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The American University in Cairo

School of Public Affairs

**REFORMING LOCAL EXTRABUDGETARY FUNDS IN EGYPT:
LESSONS FROM CHINA**

A Thesis Submitted to

The Department of Public Policy and Administration

In partial fulfilment of the requirements for

The degree of Master of Public Policy and Administration

By Domenica Gräfin von Preysing-Lichtenegg-Moos

Academic Degrees Previously Earned

M.A. (honours) History and Politics

11/2009

Student Name: Domenica Gräfin von Preysing-Lichtenegg- Moos

Thesis Title: Reforming local extrabudgetary funds in Egypt:
Lessons from China.

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Principal advisor:

First reader (and Co-advisor):

Second reader:

Department Chair:

School Dean:

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ABSTRACT:

This thesis research project “Reforming local extrabudgetary funds in Egypt: Lessons from China” was supervised by Jennifer Bremer and Khaled Zakaria Amin, and submitted to the American University of Cairo by Domenica Gräfin von Preysing-Lichtenegg-Moos.

It engages with the question of how to reform local extra-budgetary funds (EBFs) in Egypt, in explicit recognition of their high costs and risks to good budget governance, as well as their potential both, to boost local needs-based development now and, in the mean time, to provide a valuable testing ground for fiscal decentralisation reforms in the future, as the experience of China demonstrates. Progressing analytically from the general to the specific, this research starts by extracting general lessons from comparing and contrasting international public finance advice on EBFs with the experience of China in the context of national fiscal decentralisation reform since the 1980s. These provide the foundation for a SWOT analysis of the local EBF governance framework in Egypt. The final section applies both transferrable international lessons learned and national insights gained to the case of governorate-level local services and development account management, and develops short-term reform recommendations. The conclusion synthesises this research project’s findings into a single local EBF reform strategy outline for Egypt.

Findings are based on a review of the public finance literature on EBFs and on the Chinese experience, a review of the pertinent Egyptian legislation and literature, and structured, open-ended interviews with stake holding senior Egyptian officials and researchers.

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LIST OF ABBREVIATIONS

EBF	Extrabudgetary Fund
EBR	Extrabudgetary Revenue
GOE	Government of Egypt
GOPP	General Organisation for Physical Planning
IFI	International Finance Institution
LEC	Local Executive Council
LPC	Local Popular Council
LSDA	Local Services and Development Account
MoED	Ministry of Economic Development
MoF	Ministry of Finance
MoLD	Ministry of Local Development
SWOT Analysis	Analysis of Strengths, Weaknesses, Opportunities and Threats

I. INTRODUCTION

In spite of numerous decentralisation reform initiatives, Egypt so far remains one of the most centralised countries in the world. Local administrations have no taxation power and are highly constrained in their fiscal autonomy. Most local revenue derives from central government transfers, which are allocated to existing local consumption expenditure and to centrally planned investment projects with little systematic consideration for local priorities. The consequent relative absence of disposable capital at the lower administrative levels undermines localities' budgetary flexibility along with their ability to initiate local needs-based developments (Abd El-Latif: 2009; Abd El Mutallib El Ghanim: 2005; Mayfield: 1996; Sawy: 1995).

A notable exception to this state of affairs, however, is the provision for local Special Funds and the Local Services and Development Accounts (LSDA).¹ These permit localities to retain certain earmarked non-tax revenues like user charges and fines, voluntary contributions, as well as returns from revenue-generating projects and sale of public assets to finance own local expenditure programmes independently from the general budget. As such, the LSDA and local Special Funds constitute the mechanism with which all sub-national level administrations in Egypt are legally mandated to

¹ Originally according to the local administration law No. 43 / 1979 as amended: Art. 35 – 38 (governorate level); Art. 43 (district level); Art 51 & 53 (town level); Art. 69 – 71 (village level); further decrees and executive regulations govern their diverse financial sources and uses across administrations. For a more detailed legal and functional introduction to what this research identifies as 'local EBFs' in Egypt, please refer to Appendix A and section IV.1.

enhance public service levels and local socio-economic development on a local priority needs basis.

Due to the extent to which these LSDA and Special Funds share many characteristics of extrabudgetary funds in China, this research treats them as ‘extrabudgetary’ hybrids. Even if most local EBFs have recently been incorporated into the Treasury Single Account System, are formally subject to fiscal audit, and their revenues and expenditures must be reported on-budget in the aggregate, they do operate under separate budget formulation and execution procedures, are in practice subjected to highly limited budgetary control, risk diversion to uses outside their legal mandate, and overall affect the accuracy and transparency of financial accounts (as explored in later sections). In the absence of a different widely accepted term that conveys this peculiar institutional set-up, local special funds and the local services and development accounts (LSDA) in Egypt are henceforth referred to for convenience as local extrabudgetary funds (EBFs).²

At first glance, the total *recorded* volume of these local EBFs in Egypt may seem moderate: 2.62 billion LE in the FY 2007/2008, or 0.6 % of total local administration expenditure. When put in relation to total local investment expenditure, however, the volume of local EBFs in Egypt is most impressive: in FY 2008/2009, total official local EBF revenues equal about 77 % of the total 3.38 billion L.E. local capital expenditure bill for that year – a high proportion indeed, and that leaving aside unaccounted-for local contributions to EBF sponsored local projects (compare El Iman El Shawy, 2008a: 1n).

² For an introduction to the issue of defining of extrabudgetary funds in application to Chinese and Egyptian local finance and a justification for this choice of terminology, please refer to appendix A.

As the government of Egypt (GOE) is currently intensifying its budget management and decentralisation reform efforts, these local EBFs are receiving heightened attention by Egyptian policy makers and their advisors for three good reasons.

First, there is broad agreement that local EBFs are a pragmatic yet highly problematic response to wider systemic weaknesses, which hinder the realisation of national local development objectives. In this context of widespread budget system failures, LSDAs and local Special Funds³ offer important - albeit narrow - financial leeway to Egyptian local administrations to balance out shortcomings in the highly centralised national budget planning and allocation process and to initiate needs-based local socio-economic development projects. Yet, by definition, EBFs run counter to principles of transparent and accountable governance, sound fiscal policy analysis and public financial management, and are as such widely recognised gateways to corruption and embezzlement of public funds at the local administration level.

Second, the experience with EBFs in Egypt to date shows that increased budgetary powers and flexibility at the local administration level can produce impressive local development. Development-oriented governors like Adel Labib, Abdel-Salam El-Mahgoub and Fathy El Baradei have evidently made maximum use of local EBFs mechanisms to fulfil their local development mandate. Using their fee generation powers, local and business contributions, revenue-generating projects, as well as returns from developing and then selling formerly ‘dead’ public ‘capital’, these governors have been

³ For a more detailed legal and functional differentiation between these two types of local EBFs in Egypt, please refer to section IV.1

able to finance successful, large-scale local development projects through extrabudgetary channels. (Bremer et al.,2009).

And thirdly, at the same time, experience with EBFs across local administrations in Egypt shows that there is no automatic link between local budgetary flexibility and local economic development. This is because the capacity and creativity among local administrations in Egypt is highly differentiated with respect to achievements in extrabudgetary revenue generation, budget planning and financial management.⁴ Moreover, rather than investing into enhancing local economic development and public service delivery, too many local administrations are letting their accumulating EBFs lie dormant and/or ostensibly divert them to other uses outside their original legal mandate.

From these observations follows the GOE's intention, to close these uncontrolled extrabudgetary gateways to haphazard local fiscal administration in the long term and replace them with a novel, better institutional mechanism of decentralised local public finance (Burthel, personal communication, July 13, 2009). In the meantime, however, policy makers and analysts in the Ministry of Local Development are deliberating alternatives to tap local EBFs' true developmental potential and, through the achievement greater budget control, bring all local administrations into line. (Abdel Latif, Personal Communication, July 8, 2009).

⁴ Often this is related to the profile of senior local officials (refer also to section V.2.2)

II. STATEMENT OF THE PROBLEM

This thesis research project aims to contribute to this deliberation process and enquires: what to do about local extrabudgetary funds in Egypt in the near-term? What reform strategy should be adopted to maximise the local social welfare function Egypt in the short-term - by reducing local EBFs' risks and costs and enhancing developmentalist benefits?

II.1 Outline of conceptual approach

To find the best way to approach to this research topic, searching for and analysing policy advice and similar experiences on the international level is crucial as in fact, this particular reform issue in Egyptian local administration is representative of the much broader issue area of extrabudgetary Funds (EBFs) in Egypt and abroad. Generally perceived of as symptoms of budget system failure, EBFs constitute a large and persistent issue not just in the developing world, representing between 10% and 40 % of total expenditure in any country, and the search for reform policy solutions is ongoing (Allen & Radev, 2006: 11; Schiavo-Campo in Shah, 2007: 64). To be sure, EBFs can take very different forms, depending on the country context, the particular source of funding and objectives, institutional design and not least, the degree of budgetary and legislative control they are effectively subjected to: The hierarchical and vertical spectrum of EBFs

literally ranges from local “miscellaneous accounts” all the way to on-budget public agencies linked to central government.⁵

Yet, in whatever form they come, the budgetary challenges presented by extrabudgetary fund management may be reduced to a common denominator: EBFs raise sensitive questions about the degree of fiscal, political and citizen control over their use.⁶ First, with respect to fiscal budget control, EBFs by definition epitomise the transparency and accountability challenge to sound budgeting, fiscal policy analysis and public financial management. Second, with respect to political budget control, EBFs challenge the central government’s capability to dictate the objectives for which extrabudgetary expenditure is made. And third, with respect to citizen control, where EBF budget management lacks transparency, it challenges citizens’ ability to influence and monitor the appropriate spending of their contributions and the fidelity of officials to the formal rules and regulations on handling public funds.

But eventually – and this is the first premise guiding this research project’s local EBF reform proposals - it is the effective weighted combination of these three budget control dimensions - fiscal, political and citizen - that determines the effective risk to social welfare posed by extrabudgetary funds.

Hence, the second premise of this research project: fiscal control is not everything.

Technical fiscal reforms to abolish, privatise or to consolidate EBFs into the general

⁵ On the issue of defining EBFs, please refer to appendix A.

⁶ The author’s concept of budget control as presented here, is based to an important extent on Schick’s (2007 (1981)) typology of budget control along the dimensions of political, financial and internal control (see also section IV.1.3)

budget may yield disappointing results if political and public budget control to ensure compliance in the interest of the polity are lacking, be it for lack of political will or lack of capacity: “In conditions of perfect governance, a plethora of EBFs may not be a major problem; in conditions of extremely weak governance, a fully unified budget would not be a solution.” (Schiavo- Campo in Shah, 2007: 63).

This becomes clear when comparing and contrasting insights from the generalist literature by International Finance experts and the literature on the experience of China since the 1980s in particular.⁷ China’s experience shows that its proliferating local EBFs are not only costly budget system failures, which the central government has failed to eliminate for too long. It also shows that local EBFs can constitute important political economy variables in the process of economic and fiscal reform and therefore require careful attention by policy makers. For instance, local extrabudgetary special funds in the initial stages of fiscal decentralisation reform constituted a crucial ‘incentive structure’ for the lower level Chinese bureaucracy to push for record rural economic development (MacIntyre, 2000: 249; Montinola et al., 1995). And as Zhan (2008) demonstrates, the sequenced reform actions against proliferating local Special Funds in China especially since the early 1990s was a phased product of careful central government balancing acts between political (internal and external) and macroeconomic costs as well as available institutional capacity (see also Ma, 2008).⁸

⁷ On the high relevance of China’s experience for Egypt, please refer below, to section III.1.1

⁸ Sequenced Chinese central government reform actions involved the selective crack down on illegal local EBFs, and progressive on-budget consolidation and elimination of many legal EBFs (cf. section IV.2.3)

The final and *third premise of this research project is that reform proposals for local extra-budgetary funds should be measured against one clearly defined central government yardstick objective.* And the same goes for reform proposals in the budget and decentralisation reform process, generally. This research project is based on the assumption that - as in China - the guiding reform objective in Egypt is *to boost equitable local economic development and, meanwhile, produce a positive popular legitimacy by-effect.* It is believed that working out solutions on how to get there and experimenting with ways to render local EBFs' budget and financial management structure more effective can bring real local development dividends in the short term. At the same time, lessons learned thanks to short-term reforms can provide invaluable input for the formal fiscal decentralisation reform process: They can provide clues about potential optimal institutional designs for Egypt's future local fiscal administration as well as support the formation of basic social and human capital at the local level that is required to make a future decentralised fiscal administration system work.

II.2 Research Objective

Following the premises presented above (cf. II.1), and in application of lessons learned in particular from the highly relevant experience of China with local EBF reform (cf. below III.1.1), this research project develops concrete reform policy recommendations for improving the structure and budget process of the extrabudgetary local services and development accounts (LSDA) at the governorate level in view of enhancing local development outcomes.⁹

To arrive at concrete and pragmatic reform options for improving public budget control of the Egyptian LSDA, this research project progresses from the general to the specific, proceeding in analytical stages. The *three* corresponding *sets of guiding research questions* are the following:

- Macro-analytical level: What are relevant findings and recommendations regarding local EBFs by international financial institutions? How do these compare with the Chinese experience with local EBFs? What transferrable lessons on reforming local EBFs can be identified?
- Meso-analytical level: What issues and prospects can be identified with respect to the local Special Funds and LSDA in Egyptian local administration? What are main strengths, weaknesses, opportunities and threats connected to the current local extrabudgetary governance system in Egypt?
- Micro-analytical level: What policy options and reforms are to be recommended for the governorate-level LSDA in particular, and what is their implementation risk?

⁹ The rationale for choosing the LSDA as a specific reform case study are set out in section 5.1.

II.3 Previous research

Researchers' interest in the issue of extrabudgetary funds has risen markedly in recent years. A limited number of publications can therefore provide this research project with a number of valuable generalist insights. The availability of published country case studies of international experience with local EBF reforms comparable to the Egyptian case is comparatively limited, with the notable exception of China, chosen as this research's focus (cf. below III.1.1). Some research on the financial management of local Special Funds and the LSDA has been conducted in Egypt, providing sketchy and at points conflicting information on their broad characteristics and uses. To date, there has not been a focussed attempt at comparing and informing Egypt's experience with local EBFs with that of China. Nor has research explicitly engaged in a SWOT analysis of local EBFs in Egypt. And neither have concrete short-term reform options of the kind presented here been proposed to improve the budget process of the LSDAs incrementally, in view of unravelling their real developmentalist long-term potential for localities across Egypt.

III. METHODOLOGY

The methodology of this research project is described in successive stages in this chapter, in correspondence to the three sets of research questions set out under II.2. The following sections deal with first, the macro-analytical (Chapter IV), second, the meso-analytical (Chapter V), and third, with the micro-analytical level (chapter VI) of this research. A final section on the method of data collection and interpretation concludes this brief methodological discussion on the reasons for and the limitations of the methodology applied here.

III.1 On Chapter IV: The macro-analytical Level

The first research stage consists of a literature review with a focus on conceptualising local EBFs. We engage critically with relevant public finance policy analysis and advice on EBFs in relation to the experience of China with local EBFs since the 1980s in particular (macro-analytical level).¹⁰ From this comparative review, we generate a budget control reform strategy for extrabudgetary funds (EBF) in Egyptian local administration in the form of a set of transferrable general reform policy guidelines. This budget control strategy on local EBFs guides the subsequent two stages of this research project.

¹⁰ On the high relevance to Egypt of the Chinese experience with local EBFs refer below, section III.1.1

III.3.1. On the relevance of China's experience with local EBFs for Egypt

On the search for relevant international experience with reforming local EBFs with instructive potential for Egyptian policy makers, the experience of China since the 1980s in particular has been found to be particularly pertinent and has therefore been chosen as country case study. In support of this choice, a note on the transferability and instructiveness of lessons from China for Egyptian policy makers is clearly in order.

To be sure, there are many obvious differences between China and Egypt. Dramatic differences exist not only regarding the respective countries' size, culture and politico-institutional history but also with respect to the recorded volume of local EBFs. It remains disproportionately greater in China than in Egypt, both in absolute and in relative terms. Whereas in China, according to a recent estimate, local extrabudgetary revenue now accounts for about 20 % of total fiscal revenue (Zhan, 2009a:2), in Egypt it accounts only for about 2% of total fiscal revenue (calculated from El Imam El Shawy, 2009: 6, 18). Nevertheless, we contend that it is hardly far-fetched to extract lessons from the Chinese experience with reforming local Special Funds for Egypt for a number of important reasons, as set out in the following.

First, there are clear parallels between the centralised, étatist basis from which fiscal and budgetary reform processes have successfully taken off in China from the 1980s in particular and are now beginning to take off in Egypt. To an important extent, China's experience with fiscal decentralisation and budgetary reform can be regarded an instructive, future "road map" for Egypt on how a unitary, authoritarian state may

approach such reformist challenges with astounding success and without having to give up on its administration's institutionalised core characteristics:

“In both countries, party structures at the national and local level are the locus for many of the key policy decisions, whether that party is China's Communist Party or Egypt's National Democratic Party” and “in Egypt and China alike, influential private sector leaders often hold positions in the party and in local and national governing structures, such as popular councils or state-sponsored chambers of commerce.” (Bremer, 2009: 4)

A second, related point is that arguably there are notable parallels between the chief national reform policy objectives in both countries - that is, economic reform and fiscal decentralisation to enhance growth, local socio-economic development, macro-fiscal stability and state legitimacy. Contrary to what keen observers would have liked to see, democratisation has neither been the prime motivation behind nor the result accompanying the decisive decentralisation reform agenda of Chinese policy makers. Much rather, the result has been the achievement of greater popular legitimacy for the autocratic, unitary state in China.

Third, what is also worth exploring with a view to Egypt is the correlation between record rural socio-economic development and the proliferation of locally initiated and established special funds and accounts in China within the context of sweeping decentralisation and economic reforms since the early 1980s. Empirical studies support the argument that structural incentives to autonomous fiscal innovation on the local level – both within and even beyond the scope of what is formally permitted - can have significant pay-offs in terms of boosting rural socio-economic development and overall GDP growth, and along with it also popular legitimacy. What is more likely to bode quick success, allowing local experimentation or pressing for comprehensive, controlled

decentralisation via up front legal reform, or whether the two may actually be phased and/or combined is an intriguing strategic issue set for Egyptian policy makers to consider on the basis of the Chinese experience with local EBFs.

Fourth, China and Egypt share a common characteristic with respect to the unique nature of their local EBFs. As noted in the introduction, extra-budgetary funds are a common phenomenon across the world, normally intended to keep certain expenditure functions outside the regular budgetary control and approval process and to set aside a hypothecated source of funding for them. The difference between China and Egypt on the one hand, and other emerging economies like the Eastern European countries is, that in the latter EBFs are appropriated mainly from regular budgetary revenue, which is not the case, either in China or Egypt where local EBFs revenue consists of non-tax local revenues comprising contributions, fees and charges (Compare Zhan, 2008: 3). Thus, the Chinese experience is much more instructive for Egypt than that of other emerging economies.

Fifth, the Chinese experience with reforming local EBFs stands out as strikingly well researched and documented, enabling a truly multidimensional perspective on the issues surrounding local special funds and accounts. Rather than patching together a mosaic of findings on issues surrounding local EBFs across emerging economies, which is bound to be of dubious validity and instructiveness given limited, highly differentiated country data availability across countries and the very different, often unrelated research foci of studies (cf. e.g. MacIntyre, 2000; Wynne, 2005), this research prefers to focus on the single well-documented country case study of China. Especially so, because the available academic

literature on China literally allows the analyst to track a large part of the Chinese ‘lifecycle’ of local extrabudgetary funds: from the reasons why they were created and their proliferation tolerated, their benefits, risks and costs to the governance system over time, and the policy actions taken to rein them in, including real impacts made by central government so far.

Also, because the challenge of local special funds to fiscal management in China has taken on exponential proportions compared to Egypt, it offers a high-contrast “larger than life” picture of highly instructive relevance to Egypt with respect to what should be avoided and/or accounted for in the first stages of fiscal decentralisation reform.¹¹ Hence, the relative completeness and richness in contrast of the picture of local EBFs in China as portrayed in the literature allows relatively more meaningful comparisons and contrasts with the findings and recommendations of the theoretical, generalist literature published by the International Finance Institutions (IFIs) than a cross-country perspective. It therefore promises the distillation of particularly instructive lessons for Egypt.

III.2 On Chapter V: The Meso-analytical Level

In the second stage of this research project (the meso-analytical level), we clarify context-specific institutional and structural dynamics of local extrabudgetary funds in Egypt. A brief legal and functional introduction to local EBFs in Egypt sets the stage for a SWOT analysis of the local EBF governance framework in Egypt in view of upcoming fiscal decentralisation reforms.

¹¹ Note that extrabudgetary revenue in fact *exceeded* general budget revenue in China in the early nineties.

Conducted from the perspective of the central government of Egypt and based on this project's research premises (as defined above, II.1), this SWOT analysis points out the main internal strengths and weaknesses common to local extrabudgetary funds in Egypt at present. It further relates these to the future opportunities and threats inherent to this local financing mechanism - the latter with a particular reference to the fiscal decentralisation reform outlook in Egypt. The effort is guided by Bryson's (2004:124) definition of the value and purpose of SWOT analysis in public institutions, as follows:

This information can be used [...] to create ideas for strategic interventions that can shape and guide organisational decisions and actions designed to create public value. Strengths and weaknesses are usually internal and refer to the present capacity of the organisation, whereas opportunities and challenges [or threats (note by the author)] are typically external and refer to future potentials for good or ill. These distinctions between internal and external and between present and future are fluid, however..."

Thus, the SWOT analysis intends to provide a conceptual framework to inform the policy dialogue on how to enhance the developmental potential of local EBFs now, while managing their risks to sound budget management into the future.

The reader is asked to take note that the findings of the SWOT analysis presented here are to some extent generalising, in an analytical departure from the governorate-level of local administration in Egypt, which has been chosen as this research's focus. Therefore, this SWOT analysis may not have the same degree of applicability to all local EBFs at all local administration levels, given that there is in fact some variation in the institutional structure and management of the various local EBFs on the different levels of Egyptian local administration.¹² This should, however, not be considered a question of validity but

¹² For example, LSDA management on city administration level tends to display a stronger accountability link to the respective Local Popular Council than on the governorate level.

rather a matter of degree of applicability of the findings presented in Chapter V to further context-specific study of particular local extrabudgetary funds.

III.3 On Chapter VI: The Micro-analytical Level

The third and final micro-analytical stage of this research project applies both Chinese lessons learned, and national insights gained from the previous research stages. An applied case study of the governorate-level local services and development accounts (LSDA) converts these into concrete near-term EBF reform policy recommendations for Egypt. A legal-regulatory analysis of the LSDA budget structure and process offers a number of reform policy options on how to increase budget control - especially citizen budget control -, including an implementation risk assessment for each.

III.3.1 Rationale for choosing the governorate-level LSDA as a case study

A note justifying our choice of case local EBF case study is expedient. The governorate-level LSDA has been chosen as the specific reform case study out of the plethora of local extrabudgetary funds that exist on the different local administration levels in Egypt for the following main reasons:

First, the LSDA is the only type of local extrabudgetary fund that has a clear uniform legal basis across all local administrations and administration levels as defined primarily by ministerial decree number 8 of the year 1976 (“On the organisation of the services account in the local units”) and the local administration law number 43 from the year 1979. The many local extrabudgetary Special Funds that exist aside from the LSDA have structures that differ widely across local administrations due to their establishment and

governance primarily by governorate executive regulation. Also, certain special Funds only exist on certain local administration levels.

Second, focussing exclusively on the LSDA in the implementation discussion provides the analysis with greater depth without sacrificing general applicability of the proposed reform policy options. The challenges encountered in reforming the budget process for the LSDA are bound to present themselves also in the management of the local special funds.

Third, the LSDA are the local EBFs that should be targeted first to achieve greater local development in the shortest time frame. This is because they are by definition “independent” funds, which may be used for all types of expenditure, thus enabling a wide-angled project development – as opposed to the local Special Funds, which are in theory earmarked and designated for specific types of expenditure along fragmented sectoral lines.

Fourth, focussing on the governorate-level LSDA promises greatest reward in terms of local development outcomes from reform because this particular account has the highest concentration of local finance across all local administration levels and units in Egypt (El Emam El Shawy, personal communication, July 26, 2009).

Fifth, and finally, analysing and reforming the budget process of the LSDA may be considered a valuable experimental testing ground. Success or failure of reform here can provide telling lessons for the formal decentralisation reform process to come and give

clues as to what works and what doesn't in reforming Egyptian local fiscal administration.

III.4 Method of Data Collection

Three main sources inform this research project's findings on the meso- and micro-analytical level: a review of pertinent legislation, structured, open-ended interviews with stake holding senior Egyptian officials and researchers and a review of relevant literature on Egyptian local public finance. Respective strengths and shortcomings of these sources, as well as how they were dealt with, are described in turn.

The *review of Egyptian legislation and regulation* pertinent to local special funds and the services and development accounts (LSDA) has revealed the complexity of the regulatory environment surrounding local EBFs in Egypt (for a chart of key legislation please refer to appendix D). This is why this study has chosen not to provide a descriptive, full overview of the regulatory environment of local EBFs and instead to discuss it issue by issue, in direct relation to the line of argument running through chapter V and VI. Law no. 43 of 1979 (local administration law) and ministerial decree no. 8 of 1976 will find particular mention throughout this research because they may be considered legal common denominator of local EBFs across Egyptian local administrations.¹³

¹³ There are of course more common laws and regulations that apply to local special funds and accounts and their use, for example the general budget law no. 53 of 1973 as amended, the public tender law no 89 of 1998 and its amendments that governs purchases with public money, the presidential decree no. 139 of 2006 on local accountability, etc pp. For a list of key legislation refer to appendix D.

The reader is asked to take further note that in addition to what is set down by law, each and every governorate administration in Egypt can, and in most cases does, produce its own executive regulations governing each and every one of the various local special funds in its jurisdiction. These require the approval by the Ministry of Finance, where they are also supposed to be kept on archive (Diaa El Din, Personal communication, August 5, 2009). A complete review of these would have gone beyond the scope of this research.

Second, we have conducted a number of *structured, open-ended interviews* with senior representatives of Egyptian academia and government to explore further the structure and functions of local EBFs as well as the different views and approaches of senior stakeholders to the question of reforming them. (Cf. Appendix B for a list of interviewees and interview questions). The reason why not more local officials have been consulted as part of the formal interviewing process is that informal consultations have shown that - in contrast to central government officials and senior researchers in the field - local officials appear to have only marginal interest in a change of the status quo, thus promising only little additional information in support of central government reform proposals.

Third, the information gained in interviews and from the legislative review was compared and contrasted in both directions with the small number of available *publications on local extrabudgetary funds and accounts in Egypt*. This was done in order to fill informational voids, clarify potential misunderstandings or contradictions on both ends, as well as to point out potential contributions to our SWOT analysis and policy recommendations. Indeed, Egyptian publications on local EBFs provide only sketchy information as to their

broad characteristics and uses. It should be noted, however, that these can only be as complete and accurate as the information willingly provided - an inherent limitation, which equally affects our present research project.

IV. TOWARDS A LOCAL BUDGETARY REFORM STRATEGY: INSIGHTS FROM THE LITERATURE

The literature on extrabudgetary funds with particular relevance to the reform policy debate in Egypt on local Special Funds and the LSDA falls broadly into two main categories. The first ‘theoretical-generalist’ category comprises publications by the International Finance Institutions, including the IMF, the World Bank and the OECD (hereafter referred to as ‘IFI literature’). The second ‘empirical’ category encompasses precious few developing country case studies on EBFs, of which the Chinese experience with local EBFs has been singled out as country case study to guide this research project’s budgetary reform strategy (due to its particular relevance to the Egyptian policy debate for reasons explored above, section III.1.1).

This chapter aims to clarify the issue sets emerging from the theoretical- generalist and the empirical literature on extrabudgetary funds in Chinese local government, and to compare and contrast their respective reform policy strategy implications with particular relevance to Egypt (as discussed in later sections). The first section of this chapter presents the findings of the normative IFI literature on the reasons for creating extra-budgetary funds, their attendant risks and costs, and main policy recommendations. The second section begins by identifying the primary issue sets emerging from the Chinese experience with extra-budgetary funds on the local administration level and compares and contrasts these with the findings and recommendations of the theoretical IFI literature as

developed in the preceding section. It then goes on to present briefly the Chinese experience with local EBFs since the early 1980s with a focus on central government efforts to restrain them and later on, to manage and eliminate them. The third, concluding section of this part sums up insights gained from the IFI literature and the experience of China and sets out its implications for this thesis project's research agenda in Egypt in the form of a catalogue of transferrable policy guidelines on reforming local EBFs. This budget control strategy on local EBFs is going to guide the application stage of this research to Egypt in the remainder of this study.

IV.1 Insights from the public finance literature on extra-budgetary funds

Note that the IFI literature deals with local special funds and accounts as part of the wider issue area of EBFs. Three findings stand out from the IFI literature review:

1. Public finance experts in the IFI literature tradition are highly critical of EBFs, emphasising their aggregate macroeconomic costs and risks to good governance because they run counter to the discipline's cardinal principles of sound budgeting and prudent financial management (Kraan, 2004). Most authors treat EBFs chiefly as symptoms of budget system failure and lacking fiscal administration capacity in developing countries. Exceptions are Schick (2007) and Allen and Radev (2006) who apply an expanded analytical spectre to consider political economy factors of EBFs in addition to budget system failures.
2. Policy recommendations in the IFI literature advocate local EBFs' consolidation into the budget and, where feasible, their merger as well as abolition. The third

option, quasi-commercialisation of special funds in application of the public agency model¹⁴, is not recommended for developing countries. Because EBFs are considered manifestations of underlying structural budget system failures, recent publications in this literature strand emphasise the need to deal with them as part of a comprehensive, phased budget system reform strategy (Allen, 2008).

3. The strong emphasis in the IFI literature on the technical aspects of budget and governance reform to enhance sound budgeting practice as well as publications' generalist policy advocacy function has been found to constrain its explanatory scope with respect to the experience with local EBF reform in emerging economies, namely in China. As explored in greater detail below (section IV.2), the observed correlation between impressive local economic development and the persistence of EBFs in China along with the evolving central government policy on local EBFs opens up questions regarding the IFI literature's intransigent focus on the abolishment as well as cost and risk management of EBFs over the complex reasons for - and potential benefits even - of their existence, within particular governance configurations over time.

¹⁴ A prominent example of the public agency model is found in Britain: the QUANGOs (quasi-nongovernmental organisations), or NDPBs (non-departmental public body) as they are officially called. For a technical definition of the public agency model cf. Allen & Radev, 2006: 19n. The agency model has generally been viewed as a convenient mechanism to introduce market forces and greater managerial flexibility in public service delivery as part of New Public Management (NPM) in developed countries. In the recent past the agency model has come under criticism for lacking public financial transparency and for hiding the true size of government. The success of the agency model relies on strong institutional environs and considerable public financial management capacity.

Because this chapter distils only those aspects of the literature, which are relevant to this research's enquiry on Egypt, the terms 'local EBFs' and 'local special funds and local services and development accounts (LSDA)' are used interchangeably.

IV.1.1 Reasons for creating local EBFs

To be sure, reasons for creating and perpetuating local EBFs – and conversely, eliminating them - invariably depend on the specific policy context under analysis. Nevertheless, a number of general rationales may be discerned in the IFI literature. First, economic arguments for EBFs are noted in this section before presenting second, the rationales provided by budget system failure in developing country contexts, and third, the political economy factors, which support the proliferation and persistence of EBFs. Together with the costs and risks of EBFs as identified in the subsequent section, they provide the conceptual framework within which the IFI literature proposes its policy recommendations on local EBFs.

IV.1.1.1 Financial rationale: The benefit principle of taxation and earmarking

Because special funds are by definition established for a particular expenditure purpose and financed from earmarked tax and/or non-tax revenue streams, such as user charges, fines, sale of goods and services and/or transfers from the central budget, they have been analysed in the context of two related principles: the *benefit principle* of taxation and the *principle of earmarked taxes*.

The benefit principle in public finance holds that the benefits accruing to citizens from government expenditure programmes should be matched with the requirement to pay in

order to establish a link between individual payments and benefits. Considered an essential requirement of fiscal efficiency in local government, the benefit principle is of particular relevance to local administration levels, not least with a view to fiscal decentralisation reforms in Egypt. This is because there are local variations in preferences, ability to pay for, and the costs of supplying government services, of which local officials tend to have superior knowledge. Accordingly, because of their superior access to local constituencies, local authorities should be able to mobilise identified benefits-based revenues more effectively and extensively than the more remote central government - and that at lower information and transaction costs (Amin, 2006:4; Dorotinsky, 2008).

Earmarking refers to dedicating specific revenues to specific expenditure purposes. While public finance experts tend to disapprove of earmarking for introducing rigidity in the general budget and distorting the free allocation of funds among competing demands, earmarking has also been advocated as a good strategy in developing country contexts to decompose the budget into items and thus render it more transparent. In this view, budget allocations on the basis of earmarking may better reflect citizens' preferences (Allen & Radev, 2006: 18; Schiavo-Campo in Shah, 2007: 64).

Certainly, neither economic argument implies that local special funds and independent accounts have to be entirely off- budget to achieve their positive effect as cast here in terms of the benefit principle and earmarking. At the same time, however, given that both principles' underlying assumptions are less applicable in developing than developed country contexts, one can argue that decentralised local special funds are unlikely to

produce the same efficiency and welfare gains when consolidated into the regular budget system *as is*.

IV.1.1.2 Budget system failures

As briefly indicated above, the IFI literature puts strong emphasis on budget system failures in accounting for the creation, persistence and - in cases like China - the rapid proliferation of local extrabudgetary funds. The following lists three budget system failure related reasons extracted from the literature, which were found to be of particular relevance in accounting for the creation and persistence of local EBFs in China and Egypt alike.

1. *Inadequate recognition of local needs in general budget allocation:* This condition pertains particularly to countries where the budget system is concentrated in central government agencies with relatively ineffective mechanisms for information transmission between the centre and the local periphery on local socio-economic conditions and budget priorities. In such a setting, local authorities are incentivized to develop alternative mechanisms to meet expenditure requirements unmet by general budget flows (Allen & Radev, 2006: 15).
2. *Counterproductive control and incentive mechanisms for public officials:* although local authorities are required to operate within the general budget system, they prefer to and find ways to operate outside it. This happens especially where formal budgetary procedures and usual bureaucratic routines are perceived as rigid, lengthy and/or not suitable at all to certain categories of expenditure. For

example, EBFs may be used to avoid implementation problems encountered in central budget execution, due to burdensome bureaucratic controls. (Schiavo Campo in Shah, 2007: 61n)

3. *“Hedging against Uncertainty”*: here, the hypothecated source of freely disposable funding becomes a way for local officials to guard against potential central budget cuts in the future or simply to bolster low general budget allocations (not least with respect to officials’ personal salaries). The motivation to create a local extrabudgetary fund in this case is to provide programme stability and predictability beyond the current budget. (Caiden, 1974:79)

IV.1.1.3 Political Economy Rationales

As we have seen, the traditional IFI literature emphasises that EBFs result from rational actor responses to budget system failures. From this follows logically that the institutional and technical development of budget systems together with capacity building in administration must aim to make EBFs redundant eventually (Shah, 2007: 1- 4). While this traditional view appears logic by inference from Western budget reform history, it is still unable to account for ‘irrational’, non- technical aspects in the establishment and persistence of local special funds and independent accounts in both developed and developing countries.

This insight has led Allen and Radev (2006) to develop a novel, more realistic conceptualisation of EBFs as the combined result of both budget system failures *and* political economy factors. However, most of the political economy factors cited by the authors pertain to the establishment EBFs at levels of government *higher* than the local level and/or to fairly sophisticated budget system settings. So far, IFI findings of acute

relevance to local EBFs of the like found in Egypt and China are limited. Still, three pertinent political economy factors for local fiscal discipline deviant behaviour may be distilled from the IFI literature with some interpretative elaboration:

1. *Hiding funds from public scrutiny*: When citing this reason, it is mostly assumed that this is “usually to permit theft and abuse” by officials (Schiavo Campo, 2007: 62) or to avoid public pressure to spend more (Allen & Radev, 2006:16). Additionally, in the classic work by Caiden (1974:79) on budgeting in poor countries it is implied that officials might also seek to hide transactions from government scrutiny to protect these funds from central reach, for a “rainy day”.
2. *Sidestepping appropriation management rules in the interest of powerful individuals*: EBFs like local Special Funds can be a welcome opportunity for influential local officials to obtain authorisation to bend appropriation management rules so that they can operate with greater flexibility and keep relatively un-scrutinised control over the funds they generate. (Schiavo- Campo, 2007: 61)
3. *Generating (local) political support for introducing new levies*: Where it can be convincingly communicated that a new levy is earmarked to benefit the locality, this can make the acceptance of the new financial burden much easier (Allen, 2007).

IV.1.2 Attendant risks and costs of local EBFs

The long list of costs and risks of EBFs to fiscal policy and to sound financial management as developed by the IFI literature can be summed up into one rule of thumb: In the aggregate, local EBFs impose significant long-term costs on the overall budget and

macroeconomic policy. Potential welfare benefits accruing from extrabudgetary funds – if acknowledged - are real only from a disaggregated, short-term perspective. Under no circumstances are potential, isolated benefits viewed as salient enough to permit permanent fiscal exceptionalism. Along these lines, the following presents a synthesis of the major issues detected in the literature.¹⁵

1. EBFs tend to proliferate and create common pool problems

The empirical observation that EBFs tend to proliferate is of primary concern to IFIs (Schiavo-Campo, 2007: 63). The resultant guiding premise of the IFI literature in assessing risks and costs of EBFs has been succinctly described by Allen & Radev: “While individual EBFs may even be considered relatively benign, their aggregate impact on fiscal flexibility and the quality of fiscal management might be serious” (2006:24). Caiden and Wildavsky (Ch.2; 1974) define this deleterious aggregate effect of proliferating EBFs as a common pool problem. The more the overall budget becomes fragmented and earmarked, the more incentive officials have to create more of them, creating a vicious cycle, whereby the national budget is curtailed in its size and flexibility to the benefit of proliferating EBFs. Potter and Diamond (1999: 25) describe this mechanism as follows:

“In the short term, financial management will be impaired because resources transferred to a special account are typically not available to the treasury for

¹⁵ Note that these arguments truly apply only where local special funds compete with the centre in terms of revenue sources (significant taxation power necessary for this to apply), for example china; it does not at this stage of the reform process apply to Egypt, where local special fund revenue generation does not by any means stand in competition with central revenue generation. Nevertheless, these points must be considered as part of a phased budget reform and decentralisation strategy.

cash management purposes. In the medium term, a shift in government priorities may be impeded by the fact that a part of the available resources is set aside for a special task.“

2. Lacking transparency and accountability of EBFs poses risks to sound financial management. By definition, EBFs constitute a challenge to international fiscal transparency standards generating concern about inefficiency as well as misuse of funds. Beyond immediate concerns about facilitating rent- seeking among self-serving officials, EBFs have been found to exert a negative aggregate effect on sound financial management along three dimensions, on:

- Fiscal discipline in terms of comprehensive budget expenditure control;
- Efficient and effective operational and cash management
- The optimal allocation of resources consistent with policy priorities;

(Allen & Radev, 2006: 23; Potter and Diamond 1999: 26, Schiavo- Campo in Shah, 2007:63, Schick, (1981) 2007: 17).

3. In the aggregate, EBFs can pose serious risks to macro-fiscal policy

The considerations of fiscal policy risks are related primarily to concerns about the negative impact of EBFs on sound fiscal analysis and policy formulation. Due to the decoupling of EBFs from the regular budget process, experts warn of EBF induced distortions in the assessment of the overall fiscal position and macroeconomic situation, including dimensions such as the true size of the public sector and its contribution to aggregate investment and savings (Allen & Radev, 2006: 22).

IV.1.3 Policy recommendations

As the foregoing discussion has shown, EBFs like the local Special Funds and LSDA in Egypt, are perceived as high risk, because they inherently run counter to the trinity of public finance: the budget principles of universality, unity, and specificity (Kraan, 2004: 121n). Although in some cases, the legitimacy of creating and maintaining Special Funds is recognised for economic reasons or as a short-term rational response to budget system failures, in general, the message of the IFI is clear: disadvantages far outweigh the advantages of EBFs (Potter and Diamond, 1999:25).

Hence, “the standard advice of international organisations to developing countries has been to avoid creating EBFs and to eliminate them as quickly as possible when they do exist.” (Schiavo- Campo, 2007: 63). Within this paradigm, however, there is variation in terms of the policy recommendations provided. These variations seem related to the respective authors’ underlying assumptions regarding the projected sophistication of the respective governance and budget system, not the particular institution that they speak for.¹⁶

Kraan (2004: 125) argues intransigently that extrabudgetary funds be consolidated into regular on-budget documentation and subjected to regular budgetary control; potential systemic repercussions find no mention. That he sees no tension between full incorporation of special funds into the regular budget and protection to the management of earmarked levies indicates that he is plainly assuming a sophisticated budget system of contemporary European style - without, however, explicitly saying so.

¹⁶ E.g. both Allen & Kraan publish with the OECD, but have clearly divergent views.

Potter and Diamond (1999: 25) take a more gradual but similar stance. They propose to push for the budgetary consolidation EBFs as a way to technically create facts in view of “persuading” authorities to consider them a legitimate part of the budget. This is viewed as a first necessary step to break institutional resistance and to enable fiscal authorities to close or reduce the number of special accounts in the longer term. However, no special attention is given to the factors that led to the proliferation of EBFs in the first place.

Allen and Radev (2006) have proposed an alternative policy route to the traditional IFI recommendation to avoid and eliminate EBFs outright. The authors emphasise the need to deal with local EBFs in the context of the broader budget and governance reform agenda to be able to arrive at meaningful solutions (2006: 32 - 34). Based on a typology of different EBFs in terms of institutional setup, funding and objective, they propose to focus on managing EBFs’ risks. Proposed are three potential policy choices in need of evaluation for any particular case of EBF, as part of a systematic, phased budget review: “whether EBFs should continue to exist, be changed in form through commercialisation or privatisation, or be abolished.” (2006: 25, 30)

Schick’s economic and political framework for extrabudgetary expenditure (originally presented to the OECD in 1981 and re-published in 2007) challenges his colleagues’ exclusive focus on fiscal budget control with a powerful three-dimensional conceptualisation of budget control, which was found to be of particular relevance for this research project.¹⁷ He defines ‘budget control’ as a dynamic result from the interaction of

¹⁷ Schick’s multidimensional view of ‘budget control’ has inspired this research project’s conceptual approach as noted above, section II.1.

political control (the government's capacity to achieve its expenditure policy priorities), financial control (in terms of financial management), and internal control (relating to the fidelity of spenders to basic norms of behaviour) and recommends:

“The relationship between government and spenders [...] operates through incentives rather than command and control [...] A comprehensive budget process might make for a better budget but not necessarily for more control. If the latter is the pre-eminent objective, governments should devise new methods of control, leaving to secondary consideration the question of whether these controls should operate through the budget process [...] governments should contemplate what might be gained and lost from this move.” (Schick, (1981) 2007: 36n)

IV.2. Insights from experience with local extra-budgetary funds: Case Study of China

A review of the literature on the Chinese experience is in many ways congruent with the findings of the IFI literature on the rationales and risks of EBFs in local government, as the following section presents. There is notable divergence, however, on the political economy factors contributing to the persistence of local EBFs, found to be the main determinant over time in the cost-benefit analyses and resultant policy stance on local EBFs by Chinese central government officials. This finding vindicates and still goes far beyond the more recently developed ‘pragmatic’ perspective in the IFI literature, as represented by Allen and Schick (as explored in the preceding section).

What follows is a comparative enquiry into empirical proof from China regarding the reasons and benefits as well as risks and costs connected to local EBFs, and how these compare to the IFI literature as discussed before. A brief chronology of budget reform in China with a particular focus on anti-local EBF policy follows. The chapter concludes on

a synthesis of insights gained in the form of a potentially transferrable local budgetary reform strategy (as the subsequent chapters on Egypt will show).

IV.2.1 China: Reasons & benefits of creating local special funds and accounts

The Chinese experience is reasonably congruent with the more generalist findings of the IFI literature on the reasons for the creation and persistence of EBFs, especially with regard to budget system failure related factors. At the same time, however, it brings into stark evidence the limited explanatory power of these technical-rational explanations compared to political economy factors¹⁸, which have taken a particularly prominent and extensive role in shaping the Chinese experience to date.

IV.2.1.1 Budget system failures

1. Inadequate recognition of local needs in general budget allocation: As pointed out by Allen and Radev, the inadequate recognition of local needs in general budget allocation proved indeed to be one important trigger in the proliferation of EBFs in local government in China, as Ma (2008:123) recounts: “Off-budgeting finance was originally a strategy of fiscal expediency in the face of the fiscal stringency that was in force in the early 1980s.” In the early reform period the creation of EBFs has therefore been generally considered a “rational reaction of local level government agencies facing budget shortages for both administrative overhead and new social and economic projects. The answer was purely economic. They are forced to find ways to supplement budgetary shortfalls.” (Lu, 2000:282) Thus, “facing the mounting pressure of fiscal shortages, local government agencies resort to extrabudgetary or self-raised revenues generated through

¹⁸ Including institutional capacity considerations

“fund raising”, fees”, and “endowments”. Normally, the government either recognises these methods as legitimate, or acquiesces to them.” (Lu, 1999: 355)

2. Counterproductive control and incentive mechanisms for public officials:

Already during the Maoist period, limited EBFs (consisting of minor taxes and surcharges) have been created and used primarily to avoid formal budgetary procedures and bureaucratic routines under the highly centralised planning regime (Oi, 1992: 105).

This still holds true for the period of the “second revolution”:

“EBR [extra-budgetary revenue] provides a more flexible and convenient funding source. With the authority to collect EBR, government agencies do not need to go through the complicated legislative and budgetary procedures as they do in order to obtain budgetary allocations. And the management of extra-budgetary funds falls within the government agencies with little intervention by superiors or outside departments.” (Zhan, 2008: 3)

3. “Hedging against Uncertainty”: On paper, the intergovernmental fiscal contract system instituted in the early 1980s, which fixed budgets over a period of up to 5 years (as opposed to the previous more uncertain, annual rhythm) would have provided heightened budget certainty compared to other developing countries (Oi, 1992: 103). But Ma and Norregaard’s (1998: 4) account of the 1980- 1993 fiscal contract tells another story: in practice, because local governments impounded locally collected shared budgetary revenues and thus weakened the national treasury, central government resorted to various ad hoc instruments to raise revenue remittances such as ad hoc fiscal contract revisions and forcing local governments to purchase public bonds below market rate. These ad hoc instruments in turn led to undesired reactions on the part of local governments, which felt penalised for having fast growing local revenues, and therefore

followed the strong incentive to further conceal their actual revenue capacities. This perverse incentive structure created a vicious circle, to be interrupted only by a set of decisive reforms in 1993 (cf. below, section 3.2.3).

IV.2.1.2 Political economy factors

As noted above, the traditional focus in the IFI literature on rational actor responses to budget system failures in accounting for the creation and persistence of EBFs like local Special Funds is severely limited in explanatory power when it comes to economically ‘irrational’ aspects in their proliferation and persistence – a political economy critique that has been raised recently from within the discipline’s ranks but has not been developed far enough, yet, to fill its explanatory potential (cf. Allen & Radev, 2006). It is hoped that observations on the EBF experience in China can contribute to a fuller conceptualisation of this recent political economy perspective on extra-budgetary activity and reform in developing countries.

Such a fuller conceptualisation requires that the basic explanatory scope adopted so far in the IFI literature is broadened to include not only the current “bottom-up” political economy perspective that perceives of EBFs exclusively as a deviation in a ‘zero-sum’ game between the localities and state, whereby local officials are the incentivised, self-interested, deviant actors and the central state government the hapless policy taker and loser. The Chinese experience highlights that this perspective needs to be coupled with a second, reciprocal “top down” political economy perspective, which also explains the creation and proliferation of EBFs in Chinese local government also from a ‘positive-sum’ game perspective. This second perspective accords to central government the role of

policy maker (as well as taker) who acts under conditions of bounded rationality to achieve best possible reform results in terms of economic development and growth in the shortest possible period of time. By ‘bounded’ we mean here, bounded by scarcity of resources, by the degree of administrative capacity and by political leverage at any particular government decision-making point in time. The following looks at both these perspectives in turn, as identified in the academic literature on China’s experience with local EBFs.

Bottom-up political economy factors:

1. *Hiding funds from public scrutiny:* particularly the literature on organisational corruption in the Chinese bureaucracy supports this political economy factor *uni sono*, explaining at length the various ingenious techniques applied by Chinese “bureau-preneurs” to hide funds from public scrutiny to both personal and collective organisational benefit. Methods applied outside regulatory controls include siphoning off budgetary revenues into EBFs, creating and maintaining so-called “small coffers” (secret saving accounts under individual names) with impounded cash from informal levies as well as from formal appropriations, and soliciting so-called “marginal” in-kind revenue from their business constituency (Lu, 1999: 356, 359; Lu, 2000: 279).

2. *Sidestepping appropriation management rules in the interest of powerful individuals:* Zhan’s systematic EBR data analysis of central government action against extrabudgetary funds in local government strongly supports this political economy factor. Central government acquiescence to EBR maximisation by local governments is demonstrably related to local political bargaining power: “the more political power a province

possessed [in terms of representation in the party rank-and-file], the less likely it was for the centre to intervene in its collection of EBR.” (2008: 23)

3. Generating (local) political support for introducing new levies: Because the literature on Chinese EBR consulted so far focuses primarily on the excesses in local revenue extraction in application of the “three unruly actions” (illicit fees, levies and apportionments), no concrete evidence for local political support for new levies is presented with the potential exception of Oi’s (1992) field study on local state corporatism in China. It suggests that local business and government interests are intimately tied up in a local institutional and fiscal incentive structure with the effect that local businesses expect their payments to be reinvested into the local economic infrastructure or at a minimum contribute to local officials’ willingness to support the business into the future by both formal and informal means.

Top-down political economy factors:

1. Incentivising local initiative and economic development:

In the initial reform phase, “in the transition from a highly centralized command economy to a decentralized system, and with ill defined central and local fiscal powers and responsibilities, EBR functions as the compensation to local agents for their lack of formal fiscal power.” (Zhan, 2008: 4) In recognition of the fact that local ability to improve public services and promote local economic development is directly related to fiscal capacity, and that regular budgetary revenue for discretionary funds is not sufficient to satisfy local needs, the central government has tended to acquiesce to local EBF initiatives - which in fact had a similar end

effect as fiscal transfers, without putting further stress on already strained administrative and fiscal capacities (compare Lu, 1999:355; Zhan, 2008: 9 – 11).

2. *Securing political support for reforms:* According to Ma (2008: 124) “the development of off-budgetary finance helped solve the “politically difficult problem” of bureaucratic restructuring by transforming the Chinese bureaucrats into supporters of market-oriented reforms.” And conversely, central government action against local EBFs is complicated by the ability of strong localities “to manipulate the implementation of central command at the local level and dodge consequent central sanction.” (Zhan, 2008: 11)
3. *‘Controlled laissez-faire’:* Local EBF management in defiance of fiscal discipline should not just be viewed as unchecked local anarchy due to lacking institutional and administrative development. For example, Zhan (2008:1) explains the divergent pattern of central sanctioning of ad hoc taxation using local special funds as follows:

“The Chinese central government is more lenient towards localities that use their revenues more efficiently and achieve higher economic development level. In a word, the centre hands out carrots to economically efficient localities but swings the stick over those inefficient ones.”

Put differently, the central government may be characterised as working strategically with “what it has” and with a keen eye on boosting local socio-economic development whilst concurrently expanding its bounds and fiscal controls. Institutional weaknesses do not prevent the government from steering a

clear course and imposing its will on underperforming localities where it is deemed appropriate.

IV.2.2 China: Risks and costs connected to local extrabudgetary funds

1. EBFs tend to proliferate and create common pool problems: This observation in the IFI literature holds true in the Chinese experience. Here, local EBFs proliferated at impressive rates: “since China’s fiscal decentralisation started in the 1980s, the volume of EBR has expanded so rapidly that in the early 1990s it even surpassed that of the budgetary revenue. Since then several rounds of central interventions and adjustments has brought down EBR to a fraction of budgetary revenue, but the absolute amount of EBR still keeps rising.” (Zhan, 2008: 2; Oi, 1992: 105) Local EBFs are also said to create common pool problems in China and “overgrazing” of local tax bases in some regions (Zhan, 2008: 6). The more the overall revenue becomes fragmented and earmarked, the more incentive officials have to create more of EBFs and increase charges and levies on a fixed tax base, creating a vicious cycle, whereby the national budget is curtailed in its size and flexibility to the benefit of proliferating EBFs:

“Under the 1980- 93 fiscal contract system, the local governments controlled the effective tax rates and bases despite the fact that they did not have the authority to alter the statutory rates and bases. They offered varying degrees of tax concessions to enterprises and shifted budgetary funds to extrabudgetary funds, thus minimising tax sharing with central government.” (Ma and Norregaard, 1998: 4).

2. Lacking transparency and accountability of EBFs poses risks to sound financial management: the literature on EBFs in Chinese local government records the significant aggregate costs connected to their proliferation. Particularly in the earlier reform period up until the early 1990s, this was further compounded by the convergence of poorly

defined and enforced local taxation rights with ineffective, decentralised financial management. As a result, EBFs' costs to sound financial management and fiscal policy in China fall mainly along the three dimensions as identified also by the IFI literature:

- *Fiscal discipline in terms of comprehensive budget expenditure control:* Because EBFs also get used for conspicuous consumption expenditure – to public and private benefit alike – rather than investment, this can lead to distorted expansion in overall consumption expenditure and waste of funds.
- *Allocation of resources inconsistent with policy priorities:* The allocation of resources consistent with policy priorities is impaired by local EBFs with respect to both efficient investment and redistribution. With large amounts of total fiscal revenue remaining outside regular budget management and „lacking cross-regional coordination and careful management, (...) redundant construction and similar regional industrial structures lead to intensified competition between regions as well as waste of resources“ (Zhan, 2008: 5). With respect to the redistributive function of fiscal allocation, the tight budgetary situation of the central Chinese government (which is in large part due to the lack of control over EBFs) not only limits overall fiscal allocative flexibility but has impeded the installation of a sizeable intergovernmental fiscal equalisation programme, required to tackle dramatic regional disparities across China (Ma & Norregaard, 1998: 8).

- *Efficient and effective operational and cash management:* Matching the expectations of IFI experts, misuse of and corruptive practices involving EBFs are widespread phenomena in Chinese local government to this day, despite sustained central government efforts against corruption, and budget reforms (Yang, 2004). Because EBFs used to be until recently collected and managed in a decentralised setting, many agencies were able to bypass institutional checks and manipulate funds to their personal economic benefit. Because of the absence of supervision, many government agencies have also exploited their power to the maximum, pursuing the so-called “three unruly actions” or “three disorders” - that is illicit charges, fines and apportionments – to raise all sorts of creative levies and charges, often in an excessive manner (Zhan, 2008: 5). Furthermore, many local governments in China for lack of centralised control underreport collected shared tax revenue levels and divert the resultant ‘surplus’ funds away from the regular budget into separate accounts, called “small coffers.” Needless to say, this illegal, unchecked practice imposes high costs on the Treasury.

3. *In the aggregate, EBFs pose serious risks to macro-fiscal policy in China:* fiscal policy instruments risk being undermined by counterproductive use of local EBFs. For example, many local agencies keep EBFs to make loans directly to enterprises in circumvention of the official bank and credit system. Oi (1992: 121) remarks “these local government sources of funding become critical when the upper levels decide to rein in growth by cutting credit.”

IV.2.3 A brief chronology of Anti- EBF policy in China

Extra-budgetary funds were originally established as a modest local extra-budgetary revenue (EBR) supplement to the regular tax-based budgetary revenue comprising various kinds of local non-tax revenue.

But since the onset of fiscal decentralisation in the early 1980s, EBFs expanded enormously both in numbers and funding levels; by the early 1990s they even surpassed the regular budgetary revenue in fiscal weight.¹⁹ EBFs' resultant aggregate costs to the public purse as well as risks to prudent fiscal policy and sound financial management have prompted the Chinese government to reign in EBR growth and regulate and control local EBFs along with related corruptive practices (Zhan, 2009b). The following is a brief chronology of main central government interventions and budget system adjustments.

In the first decade of the “second revolution”, up until the early 1990s central government was clearly concerned with the issue of proliferating EBFs and the aggregate costs they imposed on both public purse and governance. However, policy actions in this period lacked systematic nature and impact. For instance, as early as 1985 the government displayed its concern that the abuse of local EBR authority places an excessive fiscal burden on rural populations by stipulating that nontax levies on farmers should in total not exceed 5 % of their annual income – to little effect, however (Lu, 2000: 276).

¹⁹ This historical fact about local EBF growth in China seems worth consideration by Egyptian policy makers as they prepare for comprehensive legal fiscal decentralisation reform in the near future.

From the early 1990s on, the centralised approach gained strategic consistency and focus, aiming at the elimination as well as budgetary consolidation of local special funds. In the context of violent protests in rural areas against the rising burden of excessive charges and levies related to EBFs, the first decisively effective central government action happened in 1993: local special fund collection from de-collectivised state-owned enterprises was stopped, and two systematic inspections of illicit administrative fees in local government agencies were conducted. As a result, EBR decreased to 37 % of the amount recorded in the previous year, 1992 (Zhan, 2008: 7).

In 1995, the government issued a new set of local financial management and budgeting regulations. All surtaxes collected on the local level that used to belong to the extra-budgetary fund category had to be integrated into the regular budget as of 1996. All other self-raised funds were to be placed comprehensively under extra-budgetary funds control (Lu, 2000: 283).²⁰

Another complementary move against EBFs dates to April 1996. Following a nationwide review of the collection and management of EBFs the “Decision on Strengthening the Management of Extra-Budgetary Fund” was issued, which eliminated 83 previously authorised administrative fees along with 13 government funds. Moreover, a number of local fees and levies were shifted from the extra-budgetary category to budgetary revenue. The Decision also reinforced the prohibition to transfer unreported local

²⁰ It took time, however, for these directives to materialise for real - as part of the budget reforms from 1999

budgetary revenue to the EBFs and required explicit approval by the State Council for the collection of local funds. (Zhan, 2008: 7n)

From 1999, the institutional context and incentive system changed dramatically: The central Ministry of Finance spearheaded a comprehensive budget reform process in the aim to implement a more centralised, control-oriented modern public budgeting system. Its provisions with relevance to local EBFs mainly comprised the budgetary inclusion of departmental extra-budgetary funds down to the local level, the separation of revenue and spending for EBFs, the centralisation of expenditure management with a fiscal direct disbursement (FDD) system as well as the centralisation of government accounting services with the creation of a Treasury Single Account system (TSA) (Yang, 2004: 235 – 248).²¹ The accumulated impact of these measures in terms of tightening financial management and fiscal control and empowering central and local finance bureaus contributed to the resolution of many a concern about the fiscal indiscipline surrounding local EBFs, as highlighted by Ma (2008) and Yang (2004).

Worth special mention due to their centrality in gaining greater fiscal control over local EBFs are the two relatively simple but particularly effective measures of “Separating Revenue and Spending” (SRS) and “Separation of Bills and Money” (SBM) for EBFs. These effectively decoupled revenue and expenditure powers: Whereas before the authority for assessment, collection and spending had rested with the same agency with minimal supervision, agencies were now authorised only to assess and impose fines

²¹ Note that this reform entailed a complete system overhaul within a matter of few years, which most remarkably included the nation-wide implementation of zero-based and itemised budgeting.

(using payment bills issued by the finance bureau) while banks exclusively fulfil the collection function. The disbursement of funds for expenditure follows regular procedures and requires the approval by the local finance bureau²².

It has been argued that one of the main purposes of this budget system reform was to centralise and strengthen budget control through the incorporation of EBFs into the regular budget and treasury accounting system, itself designed to prevent local agencies from impounding revenue. It is noteworthy that in order to incentivise actual compliance with the new control mechanisms of EBFs and the new legal requirement of budgetary consolidation, more adequate consumption expenditure allocations for operations and officials' salaries were provided "in exchange" (Lu, 2000: 278; Lu, 1999: 358; Ma, 2008: 127 - 130; Yang, 2004: 239n; Zhan, 2008: 8). Finally, another interesting 'quid pro quo' reform measure to gain control over EBFs in rural areas has been the "tax-for-fee" reform in 2002. It abolished a number of EBFs along with many financial obligations imposed on peasants; the resultant fiscal gap was filled by a moderate increase in rural tax rates. These measures constituted a compensatory arrangement by central government, designed to reduce extra-budgetary financial burden on peasants, and to shift the local fiscal burden toward the better regulated and supervised regular tax budget (Zhan, 2008: 8; Zhong, 2003: 92). A final instructive observation on the 1999 budget reform process is that according to Yang (2004: 239 – 24a) all major reform measures have been piloted for periods between one and two years by selected provinces or ministries before the State Council approved their nation-wide endorsement.

²² Note however that while the success of these reform measures was remarkable it was not thorough (Zhan, 2009b).

In conclusion of this brief chronological outline, the preliminary impact of Chinese local EBF reforms should be noted. As a consequence of the decisive budget reforms and other central government measures accompanied by strong enforcement vis-à-vis local officials, per capita EBR of most provinces plummeted in 1993 and 1998, and in some provinces also decreased in 2002. Since the 1999 reforms, EBR has been kept at a stable small fraction of regular budgetary revenue levels (although still rising in absolute terms).²³ However, Zhan's longitudinal and cross-sectional data analysis of EBR in China in the period between 1982 and 2003 shows that the impact of reforms has not been uniform across provinces with some localities' EBR actually rising in this period. This irregularity has been found to be a function of political influence of local officials and the efficiency with which they put their EBFs to use for local economic development programmes – another empirical vindication for the political economy counterargument to international finance experts' technical, fiscal budget control oriented reform focus.

IV.3 Towards a local budgetary reform strategy: Transferrable policy advice

Clearly, taken together, the more theoretical-generalist IFI literature on local EBFs and the literature on the Chinese experience with reforming local EBFs offer a number of important insights and lessons. This section sums up this chapter's main findings in the form of seven reform policy guidelines deemed most relevant and transferrable to Egypt, as discussed in later sections. This broad budget control reform strategy for local EBFs is going to inform the subsequent application stage of this thesis research on reforming local EBFs in Egypt – that is to say, first, a SWOT analysis of local EBF governance system in

²³ cf. chart by Zhan, 2008: 27, figures post-2003 are not available.

Egypt, generally and second, the development of concrete policy options on how to reform the current LSDA budget process on the governorate administration level.

1. *As a mechanism for financing and programming local development, local extra-budgetary funds can produce significant socio-economic benefits, and reform-minded policy makers may want to consider taking immediate advantage of this insight, never mind the public finance “unorthodoxy” of such an approach. The Chinese experience dramatically highlights that even in the presence of widespread misuse of funds due to inadequate (albeit expanding) budgetary controls, economic and political benefits of the use of local EBFs for development can in fact outweigh costs to the public purse by far - if prudently managed and, ideally, only for a transitory period.*
2. *However, it appears not advisable at all, neither in the short nor in the long-term, to ignore the urgent need to develop better budget controls for local EBFs and/or eliminate them before “things get out of hand”²⁴ - as both sets of literature communicate. This is because first, local EBFs are normally both connected to underlying budget system failures and tend to reinforce them. Second, they have a tendency to proliferate and persist. Third, in the aggregate, local EBFs can impose not only significant macroeconomic costs and risks to the regular budget, but also intense costs and risks to state legitimacy, especially in poorer, rural areas as the peasant revolts in China in the early nineties illustrate (see also below, section V.1.2.4).*

²⁴ As set out in section II.1, budget control is conceived of as a result of the effective weighted combination of three dimensions of budget control - fiscal, political and public -, which in turn determines the effective impact on the local social welfare function of extrabudgetary funds.

3. *Reform measures directed against local EBFs and connected malpractices are unlikely to yield positive results unless they are carried out as part of a more comprehensive long-term budget reform strategy.* Such is the clear message from China with which the most recent IFI literature strand on reforming EBFs concurs. As the Chinese central government did, reform-minded policy makers are advised to keep a keen eye on local EBFs as part of the overall budget and decentralisation reform process, seeking opportunities to enhance their pro-development use, to integrate them into the regular budget system or to eliminate them eventually, where feasible. Policy options as they arise should continuously be analysed in terms of the yardstick objective of the state, being local economic development, and in function of overall institutional capacity.
4. *The consideration of political economy factors by policy makers is paramount to reforming local EBFs successfully.* Much more than the IFI literature would have it, the message of the Chinese experience with controlling, merging, eliminating and consolidating local special funds is to focus on institutional incentive structures, developing *quid pro quo* elements in reform proposals for them to bode well. Consider, for example, that central government acquiescence to wasteful local EBF management is similar in effect to an informal fiscal transfer. Hence, if acquiescence is no longer to be the order of the day, compensation of another form will be required to ensure local compliance. This compensation can take multiple forms in China, monetary and party political. An instance of monetary compensation has been to provide more adequate consumption expenditure allocations for operations and officials' salaries, "in exchange"

for actual compliance with newly introduced control mechanisms of local EBFs (cf. IV.2.3).

5. *Reform measures against illicit waste of funds connected to local EBFs will have no practical meaning unless explicitly, continuously and forcefully endorsed by top leadership.* In China, accountability and scrutiny of local officials and their actions, if any, is first and foremost an intra-governmental affair chaired by central government. The Chinese reform effort on this issue was rewarded because the government officially recognised the issue as a top priority and sent a clear message from the top down, that corruption and embezzlement in local administration including illicit EBF management practices are *not* tolerated – and especially not, if the respective local administration does not deliver on economic development targets. China has cultivated this message through a long-term combination of anti-corruption mass mobilisation and institutional methods since the early 1980s: passing official resolutions and internal decrees, rounds of nationwide campaigns, engaging academia in studying local EBF phenomena, annual government anti-corruption meetings to designate reform tasks for the coming year, as well as selective, severe crackdowns on deviating local administrations involving the confiscation of large EBR sums (Lu, 1999, 363).
6. *There is no quick fix to local EBFs, and visionary experimentation is essential to long-term reform success. Both sets of literature concur that the effort to gain greater budget control over local EBFs should be conceived of in phases, allow for experimentation and take account of interconnected legal, regulatory and administrative parameters for greater realism and feasibility.* The Chinese experience is a shining example that small lessons learned today, can provide the

foundation for greater achievements and further lessons learned tomorrow. As noted under IV.2.3, in China, all major budget system reform measures, including those targeting budget control of local EBFs have been piloted for periods between one and two years by selected provinces or ministries before the central State Council approved nation-wide endorsement.

7. *Local citizen budget control is potentially less costly than fiscal and political budget control measures and should therefore be considered as part of a multipronged budget control reform effort.* When devising local EBF reform measures, reform-minded policy makers likely to fare best when they pragmatically consider all three dimensions of budget control: fiscal, political *and*, not least, citizen budget control, in order to reach an optimal weighted combination of local budget control, in function of available administrative and financial resources.²⁵ While the concept of ‘citizen budget control’ finds no explicit recognition in the antecedent IFI literature review, this lesson is a logical deduction from the evidence produced by the Chinese experience that budget control can only expand to the extent that capacities at any given point in time can support it. Prudently tapping the citizen budget control capacity of local communities, in addition to central fiscal and political budget control reform measures, can enhance a central government’s ability to augment local budget control relatively faster and at lower cost, whilst supporting its larger local socio-economic development and state legitimacy objectives.

²⁵ For an application of the concept to Egypt see chapter VI below, which develops near-term reform measures to enhance all three budget control dimensions on the local administration level in Egypt

V. EXTRABUDGETARY FUNDS IN EGYPTIAN LOCAL ADMINISTRATION: AN ANALYSIS OF STRENGTHS, WEAKNESSES, OPPORTUNITIES AND THREATS

The previous chapter has concluded on a set of highly relevant and potentially transferrable insights, as derived from the public finance literature and the country case study of local EBF reform in China. Together with our research premises,²⁶ this budget control reform policy strategy is going to guide the remainder of this study on reforming local EBFs in Egypt: the SWOT analysis in Chapter V of the local EBF governance system and institutional incentive structure in Egypt; and - along with the results of the SWOT analysis - the development of concrete policy options in chapter VI on how to reform the current local services and development account (LSDA) budget structure and process on the governorate administration level.

²⁶ These research premises have been set out in the conceptual outline (cf. section II.1) and are briefly recapitulated here:

1. The effective weighted combination of the three dimensions of budget control- fiscal, political and public budget control - determines the effective risk to social welfare of extrabudgetary funds.
2. Fiscal Control is not everything. In the absence of sufficient political and public budget control, technical reforms will yield disappointing results.
3. Reform proposals should be measured against a clear central government yardstick. This research assumes that the guiding reform objective in Egypt is to boost local economic development and, meanwhile, produce a positive popular legitimacy by-effect.

V.1 A brief legal and functional introduction to EBFs in Egypt

Before proceeding to the SWOT analysis, a brief legal and functional introduction to the subject matter is expedient.

As already noted in the introduction, Egypt remains one of the most centralised countries in the world, and local administrations are therefore highly constrained in their fiscal autonomy and local decision-making powers. Add to this a rigid, highly centralised top-down budget planning and financial management system, and local needs-based development projects - along with the local economic growth these can produce – are systematically hampered.²⁷

A notable exception to local dependence on central government direction and general budget appropriation, however, is the legal provision for extrabudgetary funds on the local administration level, the local Special Funds and the local services and development accounts (LSDA).²⁸ These extrabudgetary funds (EBFs) permit localities to retain certain earmarked non-tax revenues like user charges and fines, voluntary contributions, as well as returns from revenue-generating projects and sale of public assets to finance own local expenditure programmes independently from the general budget.²⁹

²⁷ For a brief overview of the Egyptian local (fiscal) administration system and budget planning system, cf. Appendix C

²⁸ Originally established according to the local administration law No. 43 / 1979 as amended: Art. 35 – 38 (governorate level); Art. 43 (district level); Art 51 & 53 (town level); Art. 69 – 71 (village level); further decrees and executive regulations govern their diverse financial sources and uses across administrations.

²⁹ Note that, in practice, these funds are not strictly speaking earmarked as explored further below under V.1.2.2;

As such, the LSDA and Special Funds constitute the mechanism with which all sub-national level administrations in Egypt are legally mandated to support public service levels and enhance local socio-economic development on a local priority needs basis. Their resources generally accrue entirely to the localities, which can autonomously decide over their use, and any account surplus including interest on savings does not revert to the central treasury at the end of the fiscal year, but instead gets carried forward (Local administration Law no 43/1976, Art. 36, 38). Besides these broad, common characteristics there are also important structural differences among local special funds and the LSDA:

V.1.1.The local Special Funds

Local special funds on the governorate level may be broadly categorised into two types: The first type are the plethora of local Special Funds linked to the deconcentrated local administration units (the so-called directorates) of the national service ministries, for instance in the areas of housing, health, education, transportation, tourism, youth and sports, veterinary medicine and agriculture (Abd El Mutallib El Ghanim, 2005: 30).

The second type of local special funds concerns those linked by law to the governorate local administrations (generally called the Diwan). The main funds belonging into this category are the ‘economic housing fund’, the ‘land reclamation fund’ (established by art 36 of law 43/1979), and the ‘cleaning fund’ (law 10/2005 amending law no. 30/1976).

Egyptian law defines them as extrabudgetary Special Funds proper, i.e. their revenue stream, as defined by law, is in theory earmarked for their respective particular expenditure purpose, only. For example, garbage collection fees should be used to

enhance cleaning services, and nothing else (Art.1, law 10/2005). Further, it is noteworthy that the revenue streams, management and use of both types of local special funds can vary widely across Egyptian local administrations as, in addition to what is set down by law, each and every governorate administration can, and in most cases does, produce its own executive regulations governing each and every of the various local special funds in its jurisdiction (Diaa El Din, Personal communication, August 5, 2009).

V.1.2 The LSDA

The LSDA, by contrast to the earmarked special funds, can be established at every local administration level from the governorate down to the village (apart from the hayy level), and is considered an “independent” account (Sana’diq El-Mustaqila) as opposed to the local Special Funds (Sana’diq El-Khasa) described above (Abdel Wahab, Personal Communication, August 3, 2009), i.e. the LSDA funds may be budgeted and programmed autonomously by the localities, so long as they do not contradict the national general plan and its expenditures should serve to:

- Finance local revenue-generating projects
- Complete projects, for which general budget allocations do not suffice
- Raise the performance standard of general local public services
- Finance “vital and urgent” public services (art. 38, law 43/1979; art.2, decree 8/1976)

The resources of the account - according to the law - should consist of

- Fees levied by the local popular council (LPC) of the respective local administration level within the limits of the rates and categories tabled in the ministerial decree 8/1976. The LPC may also introduce new levies or raise their level, a common practice.³⁰
- Returns from revenue-generating projects³¹
- Donations, in-kind contributions, and bequests
- 50 % of the surplus collected above the general budget estimate (art. 37, law 43/1979; art.1, decree 8/1976)

On the defining extrabudgetary characteristics of the LSDA

It has already been noted in the introduction and elaborated further in Appendix A that the LSDA are considered extra-budgetary hybrids by this research project: While they have the status of extrabudgetary funds in terms of actual financial management and budgetary process, their expenditure and revenue totals are in fact reported in the annual budget as total estimates, LSDA resources are treated by law as public funds and are subject to audit.³²

³⁰ For example: surcharges on cinema tickets, hotel stays, parking fees, road tolls, etc

³¹ For example: poultry collectives, milk production collectives, public gardens, etc.

³² That the LSDA budget plan by the LSDA committee does require approval (but may not be vetoed) by the respective Local Popular Council may be another reservation to their extrabudgetary nature. However, this research project concurs with Mayfield's view that the local people's councils at the local administration level are "part of the executive branch of government and therefore do not perform "legislative" functions, in the traditional sense of the word." (Mayfield, 1996:96) This means that there is no linkage to the Egyptian legislative budget appropriation process in a true sense, which renders the LSDA extrabudgetary on this account.

The following lists five defining extrabudgetary characteristics of the LSDA in order to reinforce preceding justifications (cf. Appendix A) with more detailed information as to why they may be conceptualised and termed local EBFs:

- A special committee (formed from among the members of the local administration unit to which it belongs) manages respective LSDAs. This LSDA committee exercises „suzerain power“ and is a separate special institutional unit, by virtue of legal authorisation by higher level government (min. decree 8/1976).
- The LSDA funds may be budgeted and programmed autonomously by the local unit within a legally specified range of expenditure purposes. Within this range of expenditure purposes, the local unit to which the LSDA belongs exercises considerable digression and is not accountable to central government institutions on details of LSDA activity.
- The LSDA are separate accounts (within the Treasury Single Account system) whose funds - including interest gained - accrue entirely to the local unit to which they belong and may not be diverted to the national treasury.
- The sources of finance, which are specified for use to advance these specific expenditure purposes match those generally attributed to extrabudgetary funds and accounts: contributions, fees and user charges, sales of goods and services, sales of financial and non-financial assets, and general earmarked revenues³³ (for a typology of EBFs' sources of finance cf. Allen & Radev, 2006:14).
- LSDA financial and budget management operates according to a process defined by ministerial decree, which runs *independent* from the regular annual budgetary

³³ A percentage of the surplus revenue collected above the general annual budget estimate

process (according to decree 8/1976). That according to the Local Administration Law, the same scrutiny should apply to the LSDA as to all public funds does not fundamentally alter this core extra-budgetary characteristic.³⁴

V.1.3 The structure and distribution of local EBFs

Resources of local special funds and of the LSDA are mostly concentrated on the governorate level. The lower level administrations own very little local extrabudgetary resources; moreover, on the governorate administration level, the relative weight of total resources of special funds and accounts is considerably greater in the diwan than in the service directorates sector. El Shawy's (2008:12) study of MoF data on local EBFs in the former pilot governorates³⁵ shows that between 81 and 96 % of EBFs are concentrated in the diwan sector, leaving 4 - 19 % to the services directorates sector.

Moreover, paralleling the Chinese experience, the extent to which extrabudgetary funds are exploited as an additional local development financing mechanism appears to depend much on the profile of the official(s) in charge, the administrative capacity as well as the effective tax base of the local unit (compare Zhan, 2009a). With an average of 35 L.E. per capita local EBR nation-wide, officially recorded per capita EBR differs widely between governorates, with 12 L.E per capita in Qena to 342 L.E. in Ismailia. On the whole, governorate administrations and service ministry directorates alike are vulnerable to the

³⁴ As explored in Appendix A, this has in fact come to be considered best practice in budget financial transparency: "Extrabudgetary activities should be identified in the annual budget or an annex to the budget. [They] should be subject to audit and should publish financial statements covering all inflows and outflows and, if relevant, the allocation and return on assets." (IMF, 2007:63)

³⁵ Fayoum, Ismailia and Luxor until recently were recognised pilot governorates for decentralisation reform, before the GOE decided to have all governorates decentralise at once.

charge of using special funds and accounts not as special local development funds but as a slush fund to pay for hospitality, amenities, and running costs like electricity and water bills.³⁶ Yet again, note the significant variation between governorates: For example, Ismailia spends almost exclusively on current expenditure (only a margin of 1 % was expended on investment), while Luxor, quite the opposite, has invested the greater part of local own resources (65%) into capital expenditure (El Emam El Shawy, 2008).

V.2 SWOT analysis of the local extrabudgetary governance system

The following SWOT analysis points out the main present strengths and weaknesses common to these local extrabudgetary funds in Egypt as well as (future) opportunities and threats inherent to this local financing mechanism - the latter with a particular reference to the outlook of the LSDA in the context of the decentralisation reform process. This assessment is conducted from the perspective of central Egyptian government and is meant to provide a meso-analytical conceptual framework (cf. table below) to inform the policy dialogue on how to enhance the developmental potential of local EBFs, while managing their risks to sound budget management. This assessment is then converted into concrete near-term reform policy recommendations in the next chapter, with a focus on the governorate-level LSDA budget structure and process.³⁷

³⁶ For a number of reasons as discussed below, section V.2.2

³⁷ On the rationale of this choice of reform case study please refer above to section III.3.1

<p>S</p> <ul style="list-style-type: none"> • Compensation for (& symptom of) budget system failures • Provides the local budgetary authority & flexibility required for local needs-based development 	<p>W</p> <ul style="list-style-type: none"> • Institutional fragmentation impedes budget control & holistic local development approach • Lack of capacity to initiate/develop/implement projects • Lack of transparency (internal & external) • Lack of accountability (upward & downwards)
<p>O</p> <ul style="list-style-type: none"> • Reach new level of needs-based local development and state legitimacy • Ideal testing ground for decentralisation reforms and local building site for social and human capital 	<p>T</p> <ul style="list-style-type: none"> •Tendency to proliferate & diversify • Permanent exceptionalism impedes advances in related areas • Threat to state legitimacy

SWOT Analysis Chart: Extrabudgetary Funds in

Egyptian Local Administration

V.2.1 Strengths

The two core strengths in the status quo of local EBFs are that, first, they compensate for budget system failures in the current governance system and second, this financial mechanism provides local administration with the budgetary authority and discretion to push for local needs-based development.

Local EBFs compensate for budget system failures connected to Egypt's historic centralism.

Certainly, the most important strength of local EBFs is the extent to which they compensate for many budget system failures connected to Egypt's historic centralism— of which they are similarly symptom and epitome (cf. below, under V.2.2, to 'Weaknesses').

Local EBFs are in effect the decentralised exception that proves the rule of centralisation in Egypt, providing the only official vehicle to receive local own-resources³⁸ and to manage them autonomously from central government.

The resultant myriads of local extrabudgetary funds help Egyptian local administrations address urgent local needs when they come up - without having to recur to the rigidly regulated and lengthy bureaucratic procedures governing disbursements from the general budget. Local EBFs also enable localities to fulfil those most urgent needs, which the general budget planning process consistently fails to consider. Local EBFs also serve more generally to alleviate the negative social welfare effects of the chronic deficit in Egyptian local administration, compensating for financial shortfalls in general budget allocations and propping up meagre salaries. (Abdel Wahab, personal communication, August 3, 2009; El Emam El Shawy, 2008a: 1n; Sawy, personal communication, July 20, 2009).

EBFs provide local administrations with the required budgetary authority and discretion to push for local needs-based development.

The other core strength of local EBFs is that local budgetary authority and considerable managerial flexibility is a major factor in the initiation and implementation of important local investment and service development projects in many governorates across Egypt. Famous examples for the impressive developmental results to be achieved with innovative local EBF management and skilled local infrastructure project planning are the

³⁸ Mainly: earmarked local fees and fines, foreign grants, voluntary local contributions, self-generated revenues from particular services and/or sale of public assets.

administrations of governors Mahgoub and Labib in Alexandria, Labib's earlier tenure in Qena governorate, and Governor El Baradei's administration in Damietta (Bremer et al., 2009).³⁹ But there are many more, less so publicised and debated, smaller-scale local achievements in generating employment, and enhancing local socio-economic development across Egypt that crucially rely on local EBFs for their implementation. These prove that even relatively modest amounts of local own revenues can enable administrations to respond better to local needs than if they were to rely on central transfers only (Abdel Wahab, personal communication, August 3, 2009).⁴⁰

V.2.2 Weaknesses

In assessing the current weaknesses of local EBFs in Egypt, it is important to differentiate between 'cause' and 'effect' in order to avoid analytical confusion. The negative effects of underlying weaknesses in the structure and management of local EBFs are obvious: the lack of use, suboptimal use, "grey" use⁴¹ and the misuse of extrabudgetary funds that leads to lower than desired development outcomes at the Egyptian local administration level. The structural causes for these phenomena are another matter, presented here selectively for discussion: Institutional fragmentation, limited local administration capacity, lack of internal and external transparency, and lack of top-down and bottom-up accountability. It is worth noting that at their core, these structural weaknesses of the local EBF governance system described here also pertain to

³⁹ Providing detail on these experiences lies beyond the scope of this research project; for further information please consult Bremer et al. (2009)

⁴⁰ As noted in the introduction (chapter I), the volume of local EBFs equals about 77 % of total local capital expenditure in the FY 2008/2009 (cf. El Iman El Shawy, 2008a: 1n).

⁴¹ "Grey" use refers to uses of EBFs that are compliant with the letter of the law while violating its spirit and intent.

aspects endemic to the overall financial management system in Egypt (compare IMF, 2006).

Institutional fragmentation and lack of clarity about what is permitted impede both budget control and a holistic approach to local development.

As alluded to in our brief introduction to local EBFs in Egypt (Cf. section V.1), local special funds and accounts are not only copious but their structure in effect duplicates the sectoral fragmentation of central government on the local level (with the exception of the LSDA). This institutional fragmentation is one major issue impeding the productive investment of local special funds into local development projects, because it unduly complicates local financial management along with the practical task of project planning for local development. Moreover, it inhibits localities from adopting a wider than sectoral approach to local development: Many promising local development project ideas struggle to materialise simply because they transcend sectoral boundaries and do not fit with the expenditure requirements of (a) particular local special fund(s).

Where special funds are instead “made to fit” the project in the interest of the local constituency, for example by spreading a non-authorised local investment project expenditure over a number of authorised expenditure categories of various funds, audacious administrations quickly find themselves operating in the legal grey zone (Abdel-Latif, personal communication, July 9, 2009). Moreover, there is lack of clarity as

to what is actually permitted/acquiesced to in the area of EBF management, further reinforced by strong ambiguity in regulatory enforcement.⁴²

The interpretative leeway thus enjoyed by individual administrations is effectively a function of their strategic value and senior officials' political clout. It is the citizens of the less daring, less knowledgeable and less connected local administrations who ultimately loose out due to institutional fragmentation and to the opaque complexity of EBF rules and regulations - rendering the current system ineffective and highly inequitable in terms of local development outcomes.

Limited local administration capacity in managing EBFs is an important obstacle to local improvement.

Another point of weakness in the local EBF system at present is shortcomings in the capacity of many local administrations to identify and develop their own projects. They lack appropriate needs-assessment and implementation guidelines and they lack the technical know-how to maximize the developmental potential of the resources at their disposal (Abdel-Latif, personal communication, July 9, 2009).

One example in point are the master plans for small cities and villages in Egypt developed locally with the support by the General Organisation of Physical Planning

⁴² According to anecdotal evidence, a former mid-level government official (chief of quarter in Port Said) was dismissed dishonourably from public office 13 years after he had unwittingly misaccounted for a LE 50 petrol expenditure for driving central government visitors (Sawy, personal communication, July 20, 2009) - clearly a minor offence compared to what normally goes without reprimand., but illustrating the potential vulnerability of local officials who find themselves out of favour.

(GOPP)⁴³ and UNHABITAT. In five years, practically none of these locally identified and centrally endorsed developmental priorities have materialised due in particular to the lack of capacity of governorate executive councils to convert defined local needs into concerted, locally financed action (Shalaan, personal communication, August 3, 2009).

Lack of internal and external transparency impedes budget control over local development outcomes.

Pervasive lack of transparency⁴⁴ in Egyptian local EBF management may be considered another prime cause in accounting for unsatisfactory developmental outcomes. Detrimental to budget control in all its dimensions – fiscal, political and citizen -, lack of transparency on financial information invites officials to use grey, suboptimal and inappropriate mechanisms in managing local resources. The following explores internal and external transparency weaknesses in the Egyptian local EBF system in turn.

Internal transparency is particularly important for both fiscal budget control and political budget control. For fiscal control, transparency enables the monitoring and audit functions of the MoF and thus provides an incentive to fidelity and appropriate management of local EBFs. For political budget control, transparency permits tracking and evaluation of how localities are implementing political objectives, learning from local achievements and failures, developing best practice guidelines for local administrations,

⁴³ GOPP is the central state authority responsible for physical planning policy

⁴⁴ ‘Transparency’ in this context refers to unrestricted access for natural and legal persons to accurate, complete and intelligible information on a matter of public interest; it is considered fundamental to all dimensions of budget control, fiscal, political and citizen alike. Internal transparency refers to transparency within the state administration, particularly transparency between local and central government entities. External transparency refers to transparency between the state administration and the citizenry.

and reprimanding those officials who deliberately trespass the line where local predation crowds out local development.

Significant headway has recently been made in terms of internal transparency and cash management thanks to the establishment of a Treasury Single Account (TSA) system and the incorporation of most local special accounts into it via zero-accounts⁴⁵. Presidential decree no.139/2006 amending Law 127/1981 on local accountability makes it illegal to maintain unconsolidated subaccounts at the local level and to withhold local resources outside the TSA.⁴⁶

Nevertheless, beyond the volume of local special funds and accounts deposited in the TSA, the central GOE recognizes its highly limited knowledge about the budgets of local special funds and LSDA. The MoF receives financial information on local administration revenue and expenditure only in the “super-aggregate” and has no information about the details of local EBF project accounts. Unable to verify the accuracy of local budgets, it therefore lacks adequate data to exercise its financial budget control function, which includes the tracking of funds’ use, identification of best practices in revenue generation

⁴⁵ The establishment of a TSA system is an integral element in public financial management reform and aims for the centralisation and improvement of cash management. A treasury single account is opened at the central bank, which should include all formerly separate accounts belonging to any government entity including local administrative units. In this context, zero accounts (whose establishment must be authorised by the MoF) are accounts of government entities at banks other than the central bank. Their balance is remitted daily to parallel accounts in the TSA at the central bank. Banks, which have zero accounts are authorised to withdraw from the TSA within the limits of the zero account balance.

⁴⁶ About 3000 accounts have been incorporated, with the exception of local special fund accounts linked to the education sector. After initial technical capacity issues the system is now running well, according to most interviewees. Higher interest rates accruing to local units constitute a major compliance incentive. Most constituencies receive the actual time deposit rate (about 6 %) now, as opposed to 2-3 % local bank interest under the previous system.

and expenditure for replication and/or potentially acting against the more blatant misuses of funds (Diaa el Din, personal communication August 5, 2009).⁴⁷

Contributing to this internal fiscal transparency weakness is the fact that certain transactions are automatically exempted from fiscal reporting requirements. To be sure, according to law 9/1981, all purchases with public money must be accounted for in the local budget. However, the law gives room for the definition by circular of authorized expenditure ceilings, below which local expenditures need not be reported.⁴⁸ These authorized ceilings can reach considerable levels, up to about 20- 25,000 L.E. for the governorate administration level. Avoiding the fiscal reporting of even substantial expenditure programmes hence becomes a facile, technical matter, by splitting expenses into appropriate categories (Sawy, personal communication, July 20, 2009).

Moreover, local in-kind contributions, such as building material and labour, are in general outright exempt from fiscal reporting, because the budgeting system is cash-based. This exemption shrouds from view the actual level of local community and business contributions - which in many parts may be rather significant - along with information on who is ultimately bearing the costs and reaping the benefits of local development projects, and how achievements were accomplished in a particular local constituency over time.

⁴⁷ A case in point for developmentally harmful misuse of resources is Assiut, which together with Sohag has the highest concentration of poverty in Egypt and is known for its security troubles. The governor preferred to waste most funds on the outer embellishment of the city rather than investing into vital basic infrastructure development such as running water – an urgent developmental priority in Assiut.

⁴⁸ These are defined by circular on an ongoing basis. Current average exemption ceilings are estimated to be 500 LE. For the village level, 2000- 5000 LE on the quarter level, about 10.000 LE for the city, and finally, 20.000- 25.000 L.E. on the governorate level.

External transparency on local extrabudgetary fund management, i.e. the provision of public information to citizens, is the most basic condition in developing citizen budget control. In Egypt, however, where little, if any information at all, is available to local constituents, citizens are effectively barred from assuming their role in developing greater budget control for better and more equitable development outcomes. Absent any public information on EBF revenue and expenditures, local citizens are unable to establish a link between their financial contributions and their uses,⁴⁹ let alone to evaluate the performance of and the fidelity to rules and norms of sound financial management of their local administrators. Also, with budget processes completely shrouded from public view, local stakeholders are inhibited from following or participating in the identification, development and cost-benefit assessment of local development projects.⁵⁰

The lack of top-down and bottom-up accountability mechanisms acts as a strong disincentive to further local development.

Due to missing top-down and bottom-up accountability mechanisms, local special funds and LSDA are effectively under sole control of the head of the local administration unit to which they belong. This official consequently has considerable discretion at using local EBFs, regardless of the particular legally prescribed institutional structure (Sawy, personal communication, July 20, 2009). It goes without saying that such institutional

⁴⁹ The collection of fees and fines by local authorities is not standardised, it depends on the fund and the administration in question; hence, what percentage of the money goes where remains hidden from the average citizen. For example, parking fees are collected by traffic authority, and then go in part to the tourism and/ or road maintenance authority.

⁵⁰ It is noteworthy that the transparency record in China is also – if not equally - poor. However, central government has compensated for this lack of transparency to an important extent by engaging academic research in collecting and analyzing data across local administrations, producing a considerable and still growing body of knowledge on the nature and uses of local EBFs that informs political budget control and reform policies to enhance fiscal budget control.

setups provide a formidable incentive to officials to manage local EBFs outside their legal mandate.

Systemic exceptionalism and non-standardisation of extrabudgetary structures and procedures across local administrations in Egypt means that *technical top-down and bottom-up accountability* mechanisms are elusive at present, as the following quote indicates:

“Any non-standard local special fund structure is *in theory* [emphasis added] written into by-laws and approved by the ministry of finance, which keeps record of them. But the sheer volume and diversity of these by-laws means they are of little use.” (Diaa El Din, personal communication, August 5, 2009)

But also *political top-down and bottom-up accountability* in terms of local administrations’ overall performance on developmental deliverables fall short, for several reasons. First, the officials in charge of managing local EBFs (as well as the general local budget) are not elected but are rather appointed by and serve at the pleasure of the central GOE; thus, any formal bottom-up accountability link is severed. Informal bottom-up accountability, too, is marginal, given the lack of transparency described in the previous section. Second, regarding top-down accountability, there is no evidence available indicating that senior officials, namely governors, are bound to or evaluated against any particular local economic development targets set by central government for their period in office.

This implies that the current local EBF chaos lacks even indirect, results-oriented accountability mechanisms that have proven crucial to the enviable local development

record of China (cf. IV.2.1.2). In short, in Egypt there is little to force officials to work for the realisation of local development projects. To the contrary, they get “rewarded” with interest from the central bank for doing nothing with their local extrabudgetary own resources.

V.2.3 Opportunities

The medium- to long-term opportunities presented by local EBFs (assuming that fiscal decentralisation reforms take off in Egypt) are at least as impressive as current weaknesses in Egyptian local own-resource management. This section argues that first, local EBFs present the opportunity to reach a new level of needs-based local development and state legitimacy in Egypt; second, they represent an ideal testing ground for decentralisation reforms and the best vehicle available to start now to build up local social and human capital assets for the future.

Local EBFs present the opportunity to reach a new level of needs-based local development and state legitimacy in Egypt.

We have already noted the major strength of local EBFs in that they provide local administrations with the budgetary authority and discretion they require to push for local needs-based development. Local administrations will use this power *if* they are developmentalist, knowledgeable, resourceful, and well connected. But the developmentalist potential of local EBFs can (and should) be exploited to the maximum everywhere in Egypt, provided the current institutional incentive system governing their use is adapted to reduce structural weaknesses.

One opportunity to foster this outcome is to streamline the fragmented local EBF system both legally and structurally and to merge functionally complementary local special funds. Such a reform would render local use of extrabudgetary funds more manageable and more transparent. Another less laborious medium-term option would be to provide local administrations with a comprehensive body of guidance to assist them in identifying, budgeting and implementing local projects. A “going by the book” can enable all local administrations, even the less knowledgeable and less well connected, to fulfil their legal mandate and deliver more and better public services and development to their constituencies.

Greater local achievements in delivering public goods and development can in turn strengthen popular legitimacy, which is fundamentally based on the state’s ability to deliver public goods. Local administrations are the agents of the central state; hence, the deliverables they are enabled and required to achieve are going to reflect positively on the GOE as a whole. Including the local citizenry in local development can add on further to legitimacy.

Local EBFs represent an ideal testing ground for decentralisation reforms and a promising local building site for social and human capital.

Local EBF reforms offer to the GOE a tremendous opportunity, by virtue of being an ideal experimental testing ground in the run-up to decentralisation reforms. By definition, local extrabudgetary funds are fairly isolated from the wider governance system including the central budget system and thus can be reformed or adapted with considerable flexibility and speed: by decree. It can be argued that experimenting with local fiscal

administration reforms in comparable pilot constituencies could provide information about “what works and what doesn’t”, providing invaluable clues as to the optimal future institutional design under a progressively decentralising governance system.

Such experimental reform policy options are numerous: Particular special funds and their functional activities might, for example, receive targeted support from central government to enhance their performance and later expand their responsibilities commensurate with growing funding and capacity levels. Some functional special funds belonging to the service directorates may be prepared to “graduate” for spin-off to become part of the set of expenditure functions of the relevant local administration. Another option may be to single out a local EBF to develop and test progressive budgeting methods like programme or performance budgeting. Certain local EBFs may lend themselves to making incremental, cumulative changes in the accountability mechanisms governing them (compare Abd al Muttalib al Ghanim, 2005: 31). Finally, local EBFs may be considered the best available vehicle to start building up local human and social capital now.⁵¹ The involvement, even inclusion of the local citizenry in decision-making through participatory budgeting tools can contribute significantly to local human and social capital development, as the experience of China and many more developing countries has shown.

⁵¹ “social capital . . . refers to features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions.” (Putnam, 1993:167)

V.2.4 Threats

As we have seen, the future opportunities inherent to the local extrabudgetary financing mechanisms in Egypt and their evolution and /or adaptation are indeed promising. However, the potential future threats to the central GOE posed by local EBFs are equally real, as already explored in general as part of the literature review (cf. sections IV.1.2 and IV.2.2). This section highlights three main risks found to be of particular relevance to Egypt as the GOE prepares for rapid fiscal decentralisation as China once did back in the late 1970s: First, the tendency of EBFs to proliferate and diversify; second, impaired ability to pursue other reforms resulting from institutionalizing extrabudgetary exceptionalism; third, a threat to state legitimacy if all their negative side-effects remain unaddressed.

Local EBFs have a tendency to proliferate and diversify, putting a strain on the budget system. Such proliferation and diversification is empirical fact, and becomes worse when the issue is overlooked by central government in times of rapid structural change. This in turn can have deleterious aggregate impact on the budget system, creating common pool problems like overgrazing of local tax bases, particularly in poorer areas. If the GOE is really set to pursue a reform path of rapid fiscal decentralisation, it would be well-advised to consider carefully China's salutary experience with the onset of rapid fiscal decentralisation, and strategically prepare for such future risks.

In China, there had been a fairly stable, modest volume of EBFs in China all along, but once fiscal decentralisation started in the 1980s, the volume of extrabudgetary revenue expanded so rapidly that by the early 1990s it even exceeded general budget revenues.

This development in China was compounded by the convergence of poorly defined and enforced local taxation rights with ineffective, decentralised financial management. Needless to say, this imposed massive costs on the central treasury and impeded budget management, fiscal analysis, and policy implementation. It took about a decade of serious central government action to bring the issue of proliferating local EBFs under relative control again- a costly experience, indeed, which the GOE should do its best to avoid.

Permanent local extrabudgetary exceptionalism endangers reforms in related areas.

Permanent, wholly uncontrolled extrabudgetary exceptionalism risks distorting and/or slowing down reforms in Egyptian local fiscal administration along with reforms of related elements in the budget system (cash management, budget planning and fiscal equalisation measures, for example). By definition antithetical to budgetary transparency, accountability, and streamlining, local EBFs represent a powerful institutional incentive to non-compliance, which – left wholly unchecked – can create harmful institutional path dependencies. It would be unreasonable to expect, that if local officials may bypass institutional checks, underreport and manipulate local finances in one area without having to fear for the worst, this would not spill over into other areas of the local budget system.⁵² Hence, local EBFs should either be brought into the light or, if they are to remain a hidden but tolerated variable in the budget reform function, they should be kept as small as possible. To do otherwise would be to put future decentralisation reforms at disproportionate risk.

⁵² This expectation is congruent with China's experience (Zhan, 2009b)

Local EBFs can become a real threat to internal and external state legitimacy.

As China's experience warns, proliferating local EBFs can become a threat to state legitimacy at both the internal (local-to-central government) and external (government-to-citizen) level. Internally, the central government risks losing control over local administrations as the latter build autonomous fiscal resources that they can effectively keep independent from compliance with central political directives. Externally, growing levies without apparent local benefit can arouse public discontent to the extent that local EBFs may become a source of social contention and unrest, especially in poorer rural areas. A deterrent example for this can be seen in the peasant revolts in China in the 1990s (Zhan, 2009a: 6).

VI. APPLIED CASE STUDY: REFORMING GOVERNORATE-LEVEL LOCAL SERVICES AND DEVELOPMENT ACCOUNT MANAGEMENT

The reform policy guidelines as derived from the critical comparison of insights from the Chinese experience with the policy advice of international public finance experts (section IV.3), and the preceding general SWOT analysis of local EBFs in Egypt (chapter V) inform the following proposal of short-term reform policy options for the governorate-level LSDAs.⁵³

The purpose of this chapter is to illustrate possible ways, in which the preceding SWOT analysis can be translated into concrete policy action by the GOE in the system *as is*, independent of any changes in the overall budget system of Egypt. Thus, the objective of following reform proposals is to illustrate how fairly limited changes by decree can help reduce current weaknesses in local extrabudgetary account management (as defined above), and to capitalise on its strengths as the only mechanism available at present to boost comprehensive local needs-based development. At the same time, by presenting an array of short-term options without pre-imposed prioritisation, we invite policy makers to discuss the nature of and experiment with building the “right” local institutional foundation for upcoming decentralisation and budget reforms in Egypt.

⁵³ As discussed in greater detail above (section III.3.1.), the governorate-level LSDA has been chosen as the specific reform case study, because it is the only type of local EBF with a clear uniform legal basis across all local administrations and administration levels in Egypt. Hence, focussing exclusively on the LSDA in the implementation discussion can provide the analysis with greater depth without sacrificing wider applicability of proposed reform policy options. Moreover, because LSDA funds are mainly concentrated on the governorate level, and can be used “independently” for all types of expenditure, reform in this area promises the most certain reward in terms of swift local development outcomes from short-term local EBF reform.

The following is a problem-oriented, legal-regulatory analysis of the LSDA revenue and expenditure structure and of three crucial stages in the LSDA budget process. Focussing on ‘policy deliberation and budget preparation’, ‘budget authorisation’, and ‘budget monitoring and evaluation’, we propose reform policy options to tackle the core issues such defined, and present a brief implementation risk assessment for each reform policy area.

V.1 A problem-oriented analysis of the LSDA structure and budget process:

Some issues and reform options

What follows is a legal, issue-focussed analysis of first, the LSDA revenue and expenditure structure and second, of crucial junctures in the budget process. Tracking three crucial stages in the LSDA budget cycle as defined by law - ‘policy deliberation and budget preparation’, ‘budget authorisation’, and ‘budget monitoring and evaluation’ - we propose reform policy options and provide a brief implementation risk assessment for each.

The proposed reform measures put primary focus on enhancing citizen budget control rather than fiscal and political budget control because this is the stage in the process where the local constituencies can be most involved in setting the objectives for LSDA expenditure, thus promoting more transparent local investment into needs-based development. According to the senior ministerial advisor on EBFs, the Egyptian MoF recognises that under the current situation it cannot (in terms of capacity) and need not (in terms of respecting local authority over development) exercise greater control over the local own-revenue project budgets. Instead, establishing greater accountability of local

officials towards their respective constituency is thought to provide the solution (Diaa El Din, personal communication, August 5, 2009). Thus, the recurrent theme running through this local EBF reform policy case study is the ambition to improve accountability and transparency in the current institutional setup of LSDA budget management to enable greater citizen budget control for better local development outcomes.⁵⁴

There is but one important contextual precondition to the feasibility and realism of our subsequent short-term reform propositions for the governorate LSDA: If, like in China, the Egypt's main goal is to drive equitable local economic development and enhance local state legitimacy then, as in China, Egypt's senior appointed officials in local administration need to be made accountable for their local reform and development record by the top executive levels of the GOE, whether by formal or informal means. As China's experience demonstrates, strong top-down accountability of appointed central government officials is central to producing real change on the ground in a highly centralised, autocratic governance system. The proposition is not far-fetched⁵⁵ that governors should be bound to and evaluated against economic development targets set by the GOE executive for their period in office in a way that affects their future career and puts a firm example to their peers. Without such strong political economy incentive from

⁵⁴ I.e., increasing local citizens' ability to influence and monitor the appropriate spending of their contributions to the LSDA and the fidelity of officials to the formal rules and regulations on handling these local public funds. Introducing civic engagement into the general LSDA budget management process can raise public budget control significantly. To this aim, the installation of elements of participatory budgeting (PB) and participatory public expenditure management (PPEM) is considered the best means available.

⁵⁵ Note Art. 29- bis, local administration law 43/1979 as amended (added by law 50/1981): "the governor shall be held responsible before the PM for practicing his competences."

above, there seems to be little to force officials to work toward the realisation of local development projects from below, by participatory or any other means (cf. also V.2.2).

V.1.1 Expenditure

Legal provision

The legal provision on the “use of the resources of the local services and development account” states that LSDAs have another legally mandated use next to local development and upgrading of public services:⁵⁶ “the completing of projects provided for in the general plan for which the financial allotments in the governorate budget do not suffice for their execution.” (Min. decr. no. 8/1976: Ch. 2, art 2, and § 1b, translated by the author).

Issue

This may make sense if the objective of the LSDA is simply expenditure compensation for budget system failures. However, if the overarching policy objective is local development (cf. II.1), then this clause defeats the desired purpose of the LSDA as a financing mechanism exclusively for local development investment projects. For one, because it defies the benefit principle that justifies local EBFs (IV.1.1.1) in theory, and secondly, in practice, it remains open to interpretation by local officials if and when general budget apportionments are insufficient. It hence invites the currently observed excessive local current expenditure from the governorate LSDA to prop up regular local administration operations and salaries (cf. V.2.2).

⁵⁶ I.e., “the making of revenue generating projects and local services(...) funding of projects that are carried out with self-efforts, raising the level of performance of general local services(...) and spending on basic public services” (chapter 2, art 2, §1)

Recommended policy options

To avoid that LSDA resources continue to be wasted as slush funds, policy makers should consider closing this legal loophole, to match the distinctly local character of the account's revenues with a new, exclusively local character of LSDA expenditures, and to eliminate room for local interpretation of where central government budget apportionments are "insufficient".

The intuitive policy recommendation would be to abolish/cancel this provision outright (Sawy, Ali personal communication, July 20, 2009). However, such a move would ignore the fact that the general budget system does suffer from important limitations so that project allocations are more often than not off target. Unless this wider systemic issue is addressed in the medium-to long-term as part of a comprehensive budget reform strategy of the GOE, there is little use in barring local administrations from covering loose ends in centrally conceived and financed local projects where deemed appropriate, even if this risks wasting local contributions on current expenditure outside the local budgeting authority.

Rather, the immediate concern should be to *curtail* the use of the LSDA as a slush fund in the short-term. It is recommended to set a generic LSDA expenditure ceiling on supporting regular, central government projects and operations. This ceiling should be negotiated between the governorates and the MoF and the MoED in order to ensure reasonability and feasibility. This ceiling may then be phased downwards in congruence with advances in the general budget planning process.

Implementation risk assessment

The risk is that, whatever ceiling is agreed upon may not be implemented as envisioned but rather provide an incentive to local officials to remove LSDA account management further from central government sight. Already the MoF's fiscal budget control over the governorate budget along with the LSDA is remarkably low, with revenues and expenditures only listed in the "super-aggregate" with often patently incomplete or inaccurate budget reporting (cf. above, V.2.2). This is why this policy reform is unlikely to have desired effects without the parallel implementation of successful complementary policy reforms for greater local public budget control (cf. below).

V.1.2 Revenue

Legal provision

According to the law, a major part of financial resources of the LSDA consists of fees levied by the local popular council (LPC) of the respective local administration level within the limits of the rates and categories tabled in the appendix of ministerial decree 8/1976. The LPC may raise their level and may even introduce new charges (according to chapter 3, art 3, §1.6 of that same decree).⁵⁷

⁵⁷ That is, of course, in addition to: returns from revenue-generating projects, Donations, in-kind contributions, and bequests; 50 % of the surplus collected above the general budget estimate (art. 37, law 43/1979; art.1, decree 8/1976) (cf.4.1.1.2);

Issues

Authorised categories of local own revenue apart from extra-charges on hotel fees and cinema tickets are heavily focussed on the agricultural sector, and due to its datedness, the catalogue does not take account of potential local sources of local development finance under the current conditions of a much more urbanised Egypt, nor does it take account of depreciation. At the same time, not all governorate LSDA committees and LPCs are equally capable and audacious to study and pass higher or new levies commensurate with changed local conditions, even if they are authorised to do so by law. Hence certain fees have even become veritable “nuisance fees” since their introduction in the late 1970s whereby collection is more costly than revenue gained. Some governorates even outright prefer to do without them, and instead siphon off a percentage of other governorate level special funds, such as the cleaning and the housing fund (Habiba Eid, personal communication, July 16, 2009). As a result, the level of available LSDA resources for enhancing local development is highly inequitable across the nation and local revenue generation may fall disproportionately on certain local groups over others, while some LSDAs rely heavily on (quasi-) unlawful sources.

Recommended reform policy option

It is therefore recommended that the MoLD endorse an updated catalogue of authorised categories of fees and charges that brings contemporary practice and law back into line. This catalogue should be based on a nation-wide study, taking into consideration the evolution and diversification of LSDA revenue structures as well as the depreciation of the Egyptian Pound since the late 1970s when the catalogue was decreed. In order not to repeat the latter mistake, defined ceilings in this catalogue should be expressed in

percentage per unit rather than absolute monetary terms so that the guidelines keep their validity independent from currency fluctuations. Such a catalogue could even provide the basis for outlawing special fund diversions towards the LSDA in the medium term.

Implementation risk assessment

It is a known that local administrations guard the exact details of their LSDA revenue generation like a secret from central government. This likely is an important obstacle in the way of achieving a comprehensive overview over the different practices in LSDA revenue generation to inform an updated, streamlined base catalogue of authorised levies. At a minimum, local administrations should therefore be guaranteed indemnity from persecution, in case the more creative revenues run counter to current rules and regulations.

V.1.3 Policy Deliberation and Budget Preparation

Three shortcomings in the “policy deliberation and budget preparation” element of the LSDA budget process deserve particular attention by reform- and experimentation-minded policy makers: first, the oligopolistic setup of the governorate LSDA committee; second, irregular, closed deliberation on LSDA policy, projects and performance; and third, the lack of local citizen control over LSDA budget preparation.

1. On the LSDA decision-making authority: Combating oligopolistic management structures

Legal provision:

Chapter 3 of the ministerial decree number 8/1976 states that on the governorate local administration level, a committee is to be formed composed of

- The governor (acting as chair of the LSDA committee),
- General secretary of the governorate,
- One member of the local popular council (chosen by the committee itself),
- The head of the finance directorate,
- Head of planning and follow-up,
- Head of budgeting and
- The head of the village construction and development agency

The committee is to function as the “suzerain power”(Min. decr. no. 8/1976: ch.3, art. 3, § 1.2) in setting the objectives, administration and political direction of the LSDA and “the chief of the committee (i.e. the governor) is in charge of the execution of the decisions of committee and the management of its objectives in accordance with the rules set for this by the committee.” (Min. decr. no. 8/1976: ch.3, art. 3, § 1.3) ⁵⁸

Issue

As is legally defined, the LSDA committee’s composition, narrow membership, its suzerain authority over all areas of budget management, and the paramount role assigned to the governor as chief of the committee have critical accountability implications both in theory and practice. In this institutional set up, the governor effectively has complete

⁵⁸ Note that below the governorate level (the district, city and village level), the local executive committee is to assume the role of LSDA management committee.

control over the management of the account, with no accountability and/or deliberative link with the local popular council – with the exception of the one sitting member from the LPC on the LSDA committee, who is in theory appointed by the committee, and in practice appointed by the governor. There is also no involvement previewed for the heads of administrative districts, towns, quarters and service authorities within the scope of the governorate, who are important stakeholders in governorate LSDA expenditure management since governorate-wide development projects affect all sub-governorate administration levels, and vice-versa.⁵⁹

Recommended policy options

To improve this constellation characterised by close to zero formal institutional accountability, it is recommended to expand the governorate LSDA committee to allow room for a greater and more divergent range of perspectives from the constituency. The variant reform options to expand the committee and establish a firmer link to the local “legislative” are: To expand the membership quota of LPC sitting members to more than just one, and to require the LPC’s vote on candidates for the committee posts on a regular basis, rather than having the committee itself appoint them. Another option is to expand the committee to include members from civil society organisations in addition to the LPC member, all elected by the LPC and accountable to it. Elections to the post should take place on a regular basis, for example every other year, to allow regular scrutiny of committee members’ local interest representation. Additionally, the rest of the members of the executive council of the governorate, i.e. the leaders of lower than governorate

⁵⁹ Elsewhere, the law does in fact recognise these official stakeholders’ importance for the successful management of the governorate’s affairs and budget: in art. 32 of the local administration law no. 43/1979 as amended, postulates their membership of the governorate executive council.

level administration units, should at least be informed of LSDA decisions taken and asked for their feedback at crucial decision making junctures in the LSDA budget process. The latter recommendation serves to expand the local accountability scope of the governorate LSDA management, and to improve horizontal and vertical communication on it, in order to facilitate governorate-wide project development and implementation and to prevent waste in LSDA funds among the various levels of local administration within the governorate.⁶⁰

Implementation risk assessment

We recognise the trade-off between budget management flexibility on the one hand, and inclusiveness and accountability of decision-making on the other. We also recognise that the greater the involvement of stakeholders, the greater the coordination and logistics burden on already strained local administrations. There is also a risk that local officials would not follow provisions opening up the LSDA circle of trust or that new memberships to the committee and new accountability links might result in a higher information and accountability level on paper but not in practice. New members to the committee might be swiftly co-opted by the conventional committee members, and the LPC election of candidates could become a farce. Leaders of sub-governorate local units may not actually do anything constructive about the access they gain to the LSDA budget process, be it for lack of skill or willingness. But these implementation risks do not affect

⁶⁰ The reader is asked to take note that each local administration level can have an LSDA with the exception of the quarter. Information sharing is therefore important minimal condition to maximise positive externalities of LSDA use across the governorate, avoid duplication and lay a foundation for future governorate-wide cooperation on comprehensive local development investment.

the basic urgent requirement to experiment with ways of ensuring that LSDA decision-making is not monopolised or oligopolised at the cost of the local public interest.

2. On LSDA policy deliberation: Enforcing regular, more open committee deliberation on LSDA policy, projects & performance

Legal provision

The law prescribes regular, frequent committee conventions to enable a constant deliberation process on the purposes, objectives, and projects of the LSDA: “The committee convenes at least once every month at the invitation of the chief or of his representative; and the assembly of the committee shall be correct with the presence of the majority of its members.”(Min. decr. no. 8/1976: ch.3, art. 3, § 1.4)

Issue

In practice, however, this important provision is not followed; committee deliberation fails to take place on a regular basis. According to anecdotal evidence, the governor generally takes decisions pertaining to the account’s management either by himself or in cooperation with select members of the committee, with very little reliance on regular committee convention. A second, closely related issue, is that – absent of any legal provisions relating to transparency in committee deliberation - decisions are taken behind closed doors, with no requirement to publicise them either to the LPC, heads of lower level administration units or to the local constituency at large.

Recommended reform policy option(s)

To reverse this situation of close to zero formal deliberation, it is recommended that a new ministerial decree make committee meetings obligatory and introduce a penalty in case of failure to convene. Acting as watchdog over the proper management of local finances, the LPC should enforce this penalty - and benefit from it. To make LPC scrutiny of regular deliberation sessions possible, such a provision should be coupled with a transparency clause that requires at a minimum that the minutes of each committee meeting are made available immediately to the LPC.

Implementation Risk Assessment

Without parallel reform moves to render LSDA committee deliberation more transparent vis-à-vis the LPC, as suggested above, it will likely be near to impossible for the LPC or anyone else to monitor and enforce regular monthly conventions by the LSDA committee. It is thus crucial to combine obligatory conventions with increased transparency to obtain desired reform results.

3. On LSDA budget preparation: raising citizens' input and budget control over LSDA expenditure programming

Legal provision

“The way in which it [the LSDA committee] issues its decisions is by majority vote of the present members and in case of a tie the decision shall go to the side on which the head of the committee [the governor] stands. [...] The committee is permitted to form from among its members one or more subcommittees to which it delegates the study of a

portion of proposed projects as well as the presentation of a report thereon.” (Min. decr. no. 8/1976: Ch. 3, art 3 § 1. 4, 5; translation by the author)

Issue(s)

Thus the law governing policy deliberation and the budget preparation stage of the LSDA budget process does not envision any local participatory planning mechanism, nor the explicit involvement of the LPC in budget preparation. LSDA policy deliberation and budget preparation is done entirely by the closed LSDA committee - that is, if it convenes.⁶¹ The risks to enhanced, equitable local development are obvious: Budget preparation is formally monopolised by the governor and his small LSDA committee consisting mainly of appointed – not elected - senior officials. Thus there is no mechanism to ensure that decisions taken do in fact reflect local priorities and spread the benefits and costs of development projects fairly. Just like the LPC, the local constituency at large is barred from participating systematically in the process that links their local contributions with local expenditure for improved development outcomes.

Recommended reform policy option(s)

Congruent with the participatory budgeting reform trend in local administration across the world, including China, the GOE is advised to experiment with ways to ensure greater local voice in the formulation of the LSDA budget and reduce the gap between LSDA revenues and local development outcomes. To this aim, it is recommended that they

⁶¹ As we will see in the next section, the formal role of the LPC is confined to approving the LSDA budget when presented with it by the LSDA committee. Otherwise it effectively has no formal say on LSDA expenditure management. As is, the LPC only has formal authority over LSDA revenue generation.

accord a more explicit formal role to LPC- elected local interest representatives and/or mixed stakeholder groups from the constituency.

It has already been suggested to expand the LSDA committee to include a number of elected representatives from the governorate and for better coordination and communication also link it with the rest of the governorate executive committee, i.e. with the heads of lower local administration units and service directorates.

Additionally, it is recommended to give a clear legal mandate to the LSDA committee as concerns the creation of standing subcommittees for each crucial local development area, such as “basic infrastructure development”, “development in the agricultural sector”, etc. These cross-sectoral subcommittees are a promising institutional vehicle to open up and enrich the LSDA budget process to more stakeholders without necessarily adding to the workload of the LSDA committee or the LEC. Apart from taking on lower-level local administrators, these subcommittees may temporarily take on additional voluntary members from the governorate constituency for consultation and project development, and also hold public consultations to take views on potential projects as well as projects under deliberation.

Implementation Risk Assessment

Experimentation with participatory institutional structures in governorate LSDA budget preparation may encounter two important limitations. First, senior local officials are unlikely to endorse such institutional reforms without significant quid-pro-quos, because

it means a drastic change in LSDA budget management that works against vested personal interests, and produces extra work for uncertain reward.

Second, the institutional capacity to provide an effective logistical and administrative support is lacking at this stage. Targeted technical and financial backstopping is needed for such experimentation with new LSDA participatory budgeting structures to be constructive. Gathering information on local priorities is one challenge, digesting it and incorporating it into the budget is yet another. This is why it is advised that, in parallel to passing the necessary regulation, the MoLD decentralisation support unit also devise and implement a capacity building strategy to this aim.

V.1.4 Budget Approval / Authorisation

Legal provision

“The committee sets the plan for the projects to whose execution it sees from the revenue of the account [...] this plan enters into force upon the decision by the executive committee of the governorate, after the agreement of the local popular council. The [LSDA] committee shall compute a budget for the account’s projects and present it to the local council at least two months before the beginning of the financial year. This budget is issued by the authority of the governor, after the agreement of the LPC.” (Min. decr. no. 8/1976: Ch.3, art.3, §1.8, 1.9; translation by the author)

Issue(s)

The LPC completely lacks decision-making power in the budget approval stage of the LSDA, with its formal role being confined to approving the LSDA budget when presented with it by the LSDA committee. Yet, without right of scrutiny of the LSDA

budget, the moves suggested above (to expand the decision-making circle to systematically include especially elected local representatives, and to raise the accountability and transparency level in LSDA management for better development outcomes) remain practically futile. Greater voice also requires greater budget scrutiny rights.

Recommended reform policy option(s)

It is therefore recommended to strengthen the LPC's right of scrutiny over the LSDA budget. The proposed reform policy options are to give the governorate LPC veto power over the whole or parts of the LSDA budget. This has the potential to incentivise the LSDA committee to involve local stakeholders early on, in the formulation stage of the LSDA budget process.

Because true fiscal decentralisation will require according real legislative powers to the LPC, LPC budgetary empowerment with such a radical short-term reform of the LSDA budget process can simultaneously be an important stepping stone, enabling policy makers to observe the practical impact of according greater budget authority to elected local bodies in an isolated instance.

Implementation Risk Assessment

The developmental success of a new provision by ministerial decree that gives concrete scrutiny rights to the LPC is contingent upon the ability and/or willingness of the LPC to make use of its right to veto/amend the LSDA budget as appropriate. It also relies on two additional conditions: First, the LSDA budget should be prepared by the LSDA

committee in complete, accurate, and detailed manner and in a format intelligible to all sitting members. Otherwise, the LPC's ability to contribute to the LSDA budget process is likely to be frustrated. Secondly, LPC members need to have or to develop the capacity to participate actively in budgeting expenditure programmes from the LSDA (compare Andrews & Shah, in Shah, 2005:183 - 216).

V.I.5 Budget Monitoring and Evaluation

Legal provision

“The accounting unit in the general diwan of the governorate keeps account on what has been accomplished in terms of revenue collection and what has been accomplished in terms of expenditure from this amount; and this in addition to the other necessary supporting documentation for the good running of the work and the accurateness of the accounts. [...] Any spending has to be authorised by the head of the committee or whoever he delegates for that purpose and any withdrawal from this account has to be via cheques signed first, by the general secretary of the governorate and second, by the chief accountant in charge or his deputy. [...] The accounts of the income and spending of the preceding month must be prepared in the first week of each month, from the records and documents; and it *must be presented to the committee for its decision* [emphasis added].” (Min. decr. No. 8/1976: ch.3, art.3, § 1.13,1.16,1.18)

Issue(s)

LSDA performance monitoring involves both monitoring and evaluation. Monitoring requires overseeing and controlling the proper accounting for and implementation of running local development projects. Evaluation aims to establish whether money spent on

projects has produced intended results. It should typically be conducted by the governorate administration upon completion of a budget cycle to inform the next round of project budget planning. Thus both monitoring and evaluation can provide invaluable information to local policy makers about achievements, shortcomings, and room for future improvement in the LSDA budget process to reduce the gap between money spent and local development outcomes achieved.

However, central government legal requirements and directives with respect to both of these potentially crucial elements for local development - monitoring and evaluation - are wanting. And the only provision on monitoring LSDA accounting in the ministerial decree no. 8/1976 (as quoted above) violates the principle of separating strategic and operational controls in sound budget management. Thus, in the current system, the LSDA committee (and in the many cases practically just the governor) controls LSDA policy, LSDA budgeting, LSDA execution and it exercises ultimate fiscal budget control over its own doings, while political and citizen budget controls are largely absent – thus, the zero transparency and accountability LSDA budget cycle is complete. Moreover, even assuming the best intentions and skills on the part of the governor and the LSDA committee, learning from and improving on projects past is a remote possibility given that LSDA budget evaluation lacks any perceptible role in the yearly governorate LSDA budget cycle.

Recommended reform policy option(s)

The first most basic reform recommendation on the monitoring function is to transfer ultimate fiscal budget control over LSDA project budgets to the LPC budget and planning

committee by amending ministerial decree no. 8/1976 ch.3, art.3, § 1.18 so that monthly LSDA accounts must be presented to the LPC for scrutiny rather than the LSDA committee. A more advanced reform policy option would be to add to this amendment the novel introduction of legally mandated quarterly or mid-year reviews of LSDA budget execution by the LPC. These reviews should ideally take place in a meeting open to the interested public. Such external transparency may not only raise the likelihood that these actually take place but also increases points of contact with the local stakeholder community in the LSDA budget process. A third, still more advanced reform option would be to legally require a systematic role for evaluation at the end of each LSDA budget cycle.

Implementation Risk Assessment

Implementing these phased reform recommendations runs two risks: lack of willingness to comply on the part of appointed officials and lack of administrative capacity and technical know-how to enable both administrative compliance and meaningful participation on the part of local stakeholder groups. But this does not alter the desirability to start experimenting with uniform monitoring and evaluation requirements as a cornerstone of the local budget cycle now. Effective budget monitoring and evaluation is paramount to successful fiscal decentralisation, so building local capacity in one budget area today can only help respond to higher demands on and opportunities for Egyptian local fiscal administration tomorrow.

VI. CONCLUSION

This thesis research has explored how to reform local extra-budgetary funds and accounts in Egypt, in explicit recognition of their high costs and risks to good budget governance, as well as their potential both to boost local needs-based development now – as the experience of China demonstrates - and, in the meantime, to provide a valuable testing ground for future fiscal decentralisation reforms in Egypt.

Progressing analytically from the general to the specific, this research starts by extracting general lessons from comparing and contrasting international public finance advice on EBFs with the experience of China in the context of national fiscal decentralisation and budget reforms since the 1980s (Macro-analytical level). Next, we conducted a SWOT analysis of the local EBF governance framework in Egypt (Meso-level), and finally, applied both international lessons and national insights gained as we developed short-term reform recommendations on increasing budget control over the governorate-level local services and development accounts (Micro-level).

The following synthesises this research project’s findings on the different analytical levels into a single local EBF reform strategy outline for Egypt:

1. There is no quick fix to local EBFs. The core lesson from China for Egypt is that their reform should be considered part and parcel of a comprehensive, phased budget and decentralisation reform strategy whose success will depend in large part on visionary experimentation leading to broader replication and course

corrections. In China, all major budget reform measures to date, including those targeting budget control of local EBFs, have been pilot-tested (and adapted) for a period between one to three years in selected provinces or government entities before approval of nation-wide endorsement.

2. Key to success along the way is the clear definition of baseline objectives – presumed here to be boosting needs-based local development and state legitimacy across Egypt – and firm, sustained policy direction towards these objectives by the top executive of the GOE. Any reform policy option or action along the path of budget and decentralisation reform should be measured against this yardstick. Reform measures connected to local EBFs need to be explicitly, continuously and forcefully endorsed by top leadership or else, they will have little impact on the ground. This is another crucial lesson for Egypt from China, where central government has since the early 1980s consistently cultivated the message to local administrators that compliance is a must. This was done through a long-term combination of institutional reform measures, mass mobilisation and even severe selective crackdowns on deviators.
3. Studying and understanding the complex role of local EBFs in the current system of governance is key to formulating a promising reform strategy that balances the costs and benefits of local extrabudgetary funds in reference to the GOE's ultimate policy objectives. In the present, highly centralised budget system, extra-budgetary local funds and accounts not only epitomise and compensate for systemic failures, but provide the only local fiscal mechanism in Egypt for needs-

based local development that is available immediately. Again, the lesson from China is that so long as the national budget system is inadequately equipped to address acute local fiscal needs through the regular budgetary process, the local extrabudgetary system cannot be abolished entirely. Instead, policy makers should follow China's example and work realistically with "what they have" to achieve their ultimate objectives: boosting local economic development and popular legitimacy.

4. The Chinese experience demonstrates that in the absence of sufficient other local finance, local EBFs have the capacity to produce significant socio-economic benefits in the short- to medium-term despite their potentially significant costs to the national purse. However, in the longer term, China's experience also shows how local EBFs can take on disastrous dimensions in the absence of sufficient budget controls - especially so in combination with rapid fiscal decentralisation reforms. Egyptian policy makers are therefore advised to keep a keen eye on local EBFs, progressively develop better local budget controls in the short-term (as suggested in chapter VI), and better national budget controls in the longer term until eventually, the merger and/or elimination of local EBFs can become possible without jeopardising the achievement of superior local development objectives.
5. Managing local EBFs risks and costs whilst taking advantage of their strengths and opportunities as Egypt moves along the budget and decentralisation reform path requires political economy realism, as highlighted by China's budget reform history since the early 1980s in particular. Egyptian policy makers should seek to

develop sensible quid pro quo incentive structures for local administrations, if they want to reform local EBFs successfully, and to do so without obliterating local development and state legitimacy baseline policy objectives. Thus, China's lesson for Egypt is that political economy realism in recognition of how much budget control capacity is available at any given point in time can demand the application of both formal and informal incentivising measures, so long as they further overall policy goals.

6. It has been shown that the key to improving the local EBF system in Egypt lies in raising the level of budget control in its three composite dimensions - fiscal, political and citizen budget control. Longer-term fiscal budget control reforms, namely the progressive installation of the Treasury Single Account system, are already underway in Egypt.⁶² In the meantime, local engagement of citizens and their representatives in budget control is a potentially swifter, and less costly reform measure than fiscal budget control measures. Moreover, it can simultaneously enhance political budget control because it serves both presumed core objectives of the GOE - that is, enhanced local needs-based development and popular state legitimacy. In the first instance, Egyptian policy makers should hence consider improving local citizen control over local extrabudgetary funds and accounts to achieve a higher weighted combination of the three composite dimensions of budget control in a shortest time frame possible.

⁶² On TSA reforms cf. section V.2.2, p. 75

7. Short-term GOE reform policy should thus aim primarily at establishing a direct link between local budgetary flexibility and local economic development through greater citizen budget control, a recommendation consistent with the view of senior Egyptian officials and researchers in the field. Arguably, the best means available to achieve this is through the establishment of improved accountability and transparency mechanisms in local extrabudgetary budget management - by decree. Our legal-regulatory case study of reforming governorate-level local services and account budget management has provided a number of suggestions in this regard. Next to advancing the primary local development and state legitimacy goals, such a local budget control reform move can provide a dual future pay-off: reducing the costs and risks of local EBFs in the short-term as well as preparing the ground for upcoming legal fiscal decentralisation reforms.

Outlook

On a final note, the conclusions drawn here on what to do about local extrabudgetary funds in Egypt, based on lessons learned from China, tie into the most recent internal reform resolution of the GOE. The various extrabudgetary financing mechanisms currently available at the local level are to be consolidated into one nationwide, standardised and transparent local financing mechanism, open also for additional financing by both government and development partners. This so-called Local Development Fund would entail a thorough realignment of institutional incentives on the local administration level and, as such, is intended to provide a new cross-sectoral framework for the streamlining of local development programming and service delivery following harmonised guidelines.

This research project considers itself part of the current effort to figure out ways on how to get there without obliterating the Egyptian government's pressing mandate to deliver on local development needs - now.

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APPENDIX A:

Defining extrabudgetary funds in application to Egyptian local finance

Although the term extrabudgetary fund seems self-explanatory at first, a closer look at the pertinent public finance literature reveals that defining extrabudgetary funds and accounts has become less of a clear-cut technical issue than a matter of judgement on a particular fund or account's institutional set-up in terms of its relative segregation from the regular budgetary system in relation to financial management, budget procedures and control.

„The term “extrabudgetary” can be considered as an umbrella concept that may be used in several ways, each emphasizing a different aspect of the issue.” (Allen & Radev, 2006:9)

„Definition is all important. To the extent that EBFs operate under separate budget formulation and execution procedures, with their own chart of accounts, they may undermine accuracy and transparency of the financial accounts. *The term EBF is misleading, and is a remnant of an earlier era when many special funds were entirely off-budget. Today, a wider array of funds exist, some of which may be reported in the annual budget even if not approved in the budget [emphasis added].*“ (Dorotinsky, 2008)

“Extrabudgetary activities are transactions of general government entities that are not included in the central or subnational budget appropriation laws. Extrabudgetary funds are usually created by a law stating their purpose, financing, administration, and other arrangements. They may be managed by the ministry of finance, line ministries, or other spending agencies, or they may be completely autonomous.” (IMF, 2007: 63)

“A broad definition of EBF is that they constitute all resources managed directly or indirectly by administrative branches of the government outside the normal budgetary process [...] From the perspective of public expenditure management *the critical distinction between budgetary and extrabudgetary funds is the extent to which the resources are put through the normal budgetary deliberations [emphasis added].*” (Bird & Wong, 2005: 18)

Moreover, the way in which ‘budget’ is defined is also very important when conceptualising the ‘extra-budgetary’ nature of a particular fund or accounts. If the concept is restricted to annual appropriation of funds by the legislature, it captures a far more limited proportion of total fiscal transactions, whereas the concept of the consolidated (unified) budget includes both the general budget and certain extrabudgetary transactions (IMF, 2007, Manual on Fiscal Transparency).

As the literature on China’s extra-budgetary funds shows, the definition of what constitutes EBFs in a particular country context can be diverse and even change considerably over time:

„The primary motivation for the development of EBF in China, especially at the subnational level, has clearly been revenue enhancement rather than earmarking. [...] Following Soviet practice, explicit extrabudgetary funds were first created in the early 1950s as small amounts of funds set aside from centralized management and control. As the concept evolved, however, EBF came to refer to fees and funds that are not taxes or budgetary items but that nonetheless are specifically authorized by some government body. This definition leaves out significant public resources that are neither budgetary nor extrabudgetary in this sense. Such funds are variously called self-raised funds, extra-extrabudgetary funds, off- budgetary funds, or extra-system revenues. For all these reasons, it is far from simple to tell just what is being counted in references to extrabudgetary resources in China.“ (Wong & Bird, 2005:19)

In consideration of the above, this research project considers the set of Egyptian local special funds and accounts ‘extrabudgetary hybrids’ because they display many substantive ‘extrabudgetary’ characteristics: They are legally authorised separate government entities⁶³ for (a range of) specified purposes and activities,⁶⁴ financed from

⁶³ „There may, however, be *government entities with a separate legal identity and substantial autonomy, including discretion over the volume and composition of their expenditures and a direct source of revenue, such as earmarked taxes*. These entities should be treated as separate government units if they maintain full sets of accounts, own goods or assets in their own right, engage in nonmarket activities for which they are held accountable at law, and are able to ... enter into contracts.“ (GSFM, 2001, paragraph 2.24)

⁶⁴ Note that these decrees usually lack specificity and rarely contain detailed criteria for the use of funds as

earmarked revenues and run separately from the regular budgetary system in the sense that they are shielded from the general budget appropriation process and their funds may not be reverted to the central treasury (compare also Allen & Radev, 2006: 10- 13).⁶⁵

At the same time, however, from a consolidated budget perspective, they are not strictly speaking extrabudgetary: Most local funds' and all LSDAs have been incorporated into the Treasury Single Account System via a zero-accounts procedure – they are hence technically speaking not off the MoF's radar anymore. Moreover, aggregate revenues and expenditures of the local special funds and LSDAs are in fact reported *on* the annual budget as total estimates and may therefore be considered as consolidated into general budget reporting. But apart from the overall volume of activities no further information on their budgets and activities is furnished so that effectively the budget control linkage to the budget deliberations of the Egypt's legislature is absent.⁶⁶ Also, being treated by law as public funds in terms of reporting requirements and accountability clearly does not enhance their extra-budgetary quality. At the same time treatment as public funds does not defy their extrabudgetary nature either, congruent as it is with best (consolidated budget) practice in EBF fiscal transparency:

“Extrabudgetary activities *should be identified in the annual budget* or an annex to the budget. [They] should be *subject to audit* and should publish financial statements covering all inflows and outflows and, if relevant, the allocation and return on assets.” (IMF, 2007:63)

explored under section 4.1. This gives leeway to willing and capable local entities to manage the particulars of their affairs as they see fit. Many are internal documents/executive regulations known only to the relevant authorities so there is no informational accountability link to the legislature.

⁶⁵ Section 4.1 expands in greater detail on the somewhat peculiar and less clear-cut case of the LSDA.

⁶⁶ Provided, one concurs with Mayfield's argument that Egypt “is an executive-oriented system with no real legislative functions at the local administrative system level. Even the local people's councils at the various levels are considered as part of the executive branch of government and therefore do not perform “legislative” functions, in the traditional sense of the word.” (1996:96)

In the absence of a widely accepted term that conveys the peculiar institutional set-up of the local special funds and the LSDA in Egyptian local fiscal administration displaying both substantive extrabudgetary characteristics and technical on-budget characteristics, this paper has chosen to term and treat them as ‘local EBFs’ for the purposes of this research. This is considered justified to the extent to which they operate under budget formulation and execution procedures separate to the general budget system, have their own accounts, and tend to undermine the accuracy and transparency of financial accounts (as explored under chapter IV and V).

Appendix B:

List of Interviewees

Surname	First name	Position/Organisation	Place	Date
Abdel Latif	Lobna	Senior advisor to the Minister of local development	Cairo, Egypt	8th of July 2009
Abdel Wahab	Samir	Director of the Public Administration Research and Consultation Centre (PARC), Cairo University	Cairo, Egypt	3rd of August 2009
Burthel	Shyam	Chief Technical Advisor, Decentralisation programme, UNDP	Cairo, Egypt	13th of July 2009
Diaa el Din	Hussam	Senior advisor to the Minister of Finance	Cairo, Egypt	5th of August 2009
Eid	Habiba	Head of decentralisation unit, Ismailia	Ismailia, Egypt	16th of July, 3rd of August 2009
El Emam El Shawi	Mohamed	Undersecretary of the Ministry of economic development, Public finance advisor, Egyptian decentralisation Initiative (EDI), USAID	Cairo, Egypt	26th of July 2009
Sawy	Ali	Professor, Cairo University	Cairo, Egypt	20th of July 2009
Shalaan	Ihab	Project Manager, Strategic Urban Planning for Small Cities, UNHABITAT (General Authority for Physical Planning)	Cairo, Egypt	3rd of August 2009
Shehata Khattab	Abdallah	Advisor to the Macrofiscal Unit, Ministry of Finance	Cairo, Egypt	5th of August 2009

Interview questions used in standardised, open-ended interviewing

1. Status quo

- What laws and regulations govern local special funds and the local service and development accounts?
- What are the costs and benefits connected to the existence & use of local special funds at the moment?

Alternative questions depending on interviewee:

- Why do special funds exist? What are the main problems with them?
 - From your perspective, what would be the impact of eliminating special funds with the system *as is*?
- How has the installation of the TSA system affected the handling of local special funds and accounts?

Additional question depending on the interviewee: Have all accounts been incorporated into the new system?

- What are the broad trends in local funds' expenditure?

Additional question depending on the interviewee: Why do you think is there such a strong variation in the structure and the uses of local funds across constituencies in Egypt?

2. Potential reforms

- In your view, what are the primary adjustments that the current system requires in view of enhancing the effective use of local resources for needs-based local development? With respect to the following dimensions:
 - General management & decision making structure
 - Budget formulation
 - Approval
 - Implementation
 - Evaluation & monitoring
- Where do you see a potential reform of the local special funds fit into *your* broad vision of decentralisation reform? (*Alternatively, do you think there will always be a need for local special funds in Egypt?*)
- Which governmental bodies should take a greater oversight/ coordination/ capacity building role to this aim, in what ways?

3. Questions seeking detail on status quo

- What are the main revenue sources of LSDA?
- What are the different uses of the local services and development account? In particular, what are the main types of revenue generating projects and productive enterprises financed from the LSDA?

Additional questions depending on the interviewee:

- Can you explain the Mahagir (quarry) to me?
- Can you explain the road account to me?
- Apart from running local projects of course, what are the chapter 1 and 2 expenditures the funds are being used for?

APPENDIX C:

The Egyptian local administration system in brief

The Egyptian system of administration has been described as one of “administrative deconcentration without authority” (Amin, 2006:1) and as “a composite of a central unitary functional system and the hierarchical processes implied in a prefectoral system” (Mayfield, 1996: 80).

The local administration system has three levels for fully urban governorates (the governorate, city and quarter), and four levels in rural-urban governorates (governorate, administrative district, city, as well as village and quarter). A centrally appointed, senior administrative official heads each local administration unit, with the executive responsibility to represent the central government in the constituency. To name but two examples, the governor is appointed by, accountable to, and acts as representative of the president in the governorate, while the chief of the administrative districts is appointed by and serves at the pleasure of the Prime Minister.

Each local administration unit has two councils: the centrally appointed local Executive Council (LEC) - comprising the heads of lower local administration units and the representatives of public authorities and line ministry directorates on the same administrative level - and the Local People’s Council (LPC), which is elected every four years. Policy-making and budget authority lies first and foremost with the LECs, while LPCs in reality have highly limited powers beyond approving LEC policy. One can

therefore speak of “a form of *democratic centralism*, whereby the local executive councils are, at least in theory, answerable to both the elected people’s council and the higher-level central administration.”(Mayfield, 1996: 79) Generally, the system relies on top-down, vertical systems of direction and control

The Egyptian budget system in brief

On paper, the budget planning process is bottom-up and goes as follows: the Ministry of Finance sends out financial guidelines and the Ministry of economic development the technical guidelines. According to these guidelines, local budget authorities (directorates, the diwan, the LEC & LPC) draft local budgets proposals; following approval by the relevant LPC these are submitted to the next higher administration level until the governorate level which incorporates all budget proposals into one general budget proposal document, a “wish-list”; this governorate budget proposal goes to the MoLD for review and then to the MoED and the MoF who include it into the state general budget for parliamentary approval (Sawy, 1995:170; Shand, 2005: 17). In practice, the budget planning effectively starts again once available funding through the approved budget is clear: central budget priorities normally take precedence over local priorities, and where budget cuts are made, these are hard to match with projects due to the institutional fragmentation in budget preparation and execution. For example, a governorate project in the transportation sector requires the coordination of about six budget authorities⁶⁷ (Abdel Latif, personal communication, June 15, 2009).

⁶⁷ i.e. the Ministry of housing, ministry of transportation, roads and bridges authority, governorate diwan, rail authority, and the transport directorate

APPENDIX D:

Chart of key legislation⁶⁸

Decree of the Ministerial Committee for local administration no. 31/ 1967: On the financial affairs and management of productive enterprises
Law 10/ 2005 Amending Law no 30 / 1976 Regarding General Cleanliness
Local Administration Law no. 43/1979 as amended
Ministerial Decree no. 8/ 1976: Law Organizing the Local Services and Development Accounts. Ministry of Local Government
Presidential Decree no. 139/2006: On local accountability
Public Tender and Bidding Law no. 89/1998 as amended
The State's General Budget Law no. 53/1973 as Amended by Law no. 1/1979 and Law no. 104/1980, Law U.S.C. (1973).

⁶⁸ This listing is in alphabetic order